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Banking regulation and lender-of-last-resort intervention

Mathias Dewatripont

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I would like to focus my remarks in this Panel on Monetary Policy in the New Regulatory Environment on the impact of banking regulation on the role of central banks as lenders of last resort. I shall consider in turn two aspects of banking regulation that have evolved since the recent financial crisis: liquidity regulation and bail-in provisions.

1 Liquidity regulation

In the aftermath of the Lehman Brothers failure, central banks have had to play a decisive role in order to avoid the implosion of the financial system. This is because, next to insufficient capital buffers, the liquidity position of many banks – which had excessively relied on short-term wholesale funding – was clearly insufficient too. This explains why the Basel Committee devised the Liquidity Coverage Ratio (LCR), which requires banks to hold a buffer of High-Quality Liquid Assets (HQLA) to resist a short-term liquidity stress scenario, and the Net Stable Funding Ratio (NSFR), which addresses more structural liquidity mismatches. The (simple) idea is that enhanced self-insurance by banks will make financial markets more resilient, and reduce their "free-riding" on central banks, which should remain lenders of last resort and not become lenders of first resort.[1]

Over time, several worries have surfaced about the unintended consequences of these liquidity ratios, especially in the euro area and especially with respect to the LCR:

1. the potential negative consequences on (long-term) lending to the real economy;
2. the potential lack of "usability" of the HQLA buffer in crisis times, owing to stigma effects (if markets realise that a bank needs to start using its buffer);
3. the incentives it gives banks to "park lower-quality assets" (that is, assets that do not qualify as HQLAs for the LCR liquidity buffer) as collateral at the central bank in order to obtain funds.

The worry about threats to long-term lending seems at first paradoxical, since the LCR time horizon is only one month. Why would the LCR create a disincentive for banks to lend for a horizon of, say, twenty rather than five years, as is claimed by some banks? The argument could however make sense when looking at the overall risks faced by banks: very long-term lending creates significant interest rate risk, and therefore requires swaps to hedge such risk; this in turn creates counterparty risk and therefore collateral requirements, which mobilise HQLAs. In my view, this reasoning[2] (whose importance should ideally be assessed quantitatively) is not necessarily a reason to adjust regulation, since one could argue that the LCR simply restores a more correct price for liquidity. But it may mean that we should think of ways to help long-term lending.

As for usability of the buffer in crisis times, it is essential of course; otherwise we will just have managed to turn (highly) liquid assets into illiquid ones. Goodhart (2010) highlights this point by making the comparison with a taxi station, which, by requiring one taxi to always be available for customers has in fact made it useless. On the other hand, managing an "orderly" usability of liquidity buffers, that is, without triggering adverse market anxiety, is challenging. Some interesting avenues have been explored by the

[1] On such free-riding, see Fahri and Tirole (2012).

[2] I became aware of this thanks to Jeroen Lamoot.

Basel Committee in order to promote usability by adding crisis-time central bank-based second lines of defence (such as Restricted-Use Committed Liquidity Facilities, see BCBS, 2014), but this key area is still largely untested and certainly worth further investigation.

The question of usability is connected to the questions of central bank eligibility and of bank reliance on central bank lending. Since central bank-eligible assets do constitute a safe way to access liquidity, why do they not automatically count as part of the LCR HQLA buffer? The answer given by the Basel Committee is "because the LCR is about market liquidity". Indeed, the point of the LCR is to promote self-insurance by banks, not potential reliance on central banks. Moreover, since central bank eligibility is down to the central bank's choice, there was a fear of a gradual weakening of the liquidity standard by individual central banks feeling pressured to "help" their banking sectors. This debate was made more difficult because of the differing situations of the Basel jurisdictions: in a euro area in crisis, a 100% LCR does not make sense, usability is instead indicated. This fact helps explain the 2013 Basel compromise. i.e. starting in 2015 with an LCR of 60%, which is increased only gradually to 100%, in the hope that in a few years' time the crisis will have receded.

The various objections to the LCR we have just discussed do have some validity. One should however be careful not to go too far in weakening the liquidity standard, especially since the dynamics of international regulatory negotiations, where the status quo was no liquidity regulation, has naturally led to gradual softening. It is therefore important, in the EU translation of the standard, to avoid significant further weakening, if one wants to avoid making the standard irrelevant. Let us remember in particular that European Banking Authority data point to: (i) an average LCR in June 2013 of 104% for large banks (as compared to 83% one year earlier); (ii) an aggregate gross shortfall relative to a 100% LCR down to only EUR 262 billion at that date, relative to assets of EUR 31.7 trillion; and (iii) only one bank (out of a sample of 41) under 60%.

One should thus be careful not to forget why we wanted to introduce the LCR, especially given that liquidity concerns could be heightened by the current debate on bail-in, to which we now turn.

2 Capital requirements and bail-in

We are now witnessing a paradox in the aftermath of the financial crisis:

4 On the one hand, Basel III has strongly stressed: (i) the need to increase not only the quantity of capital banks hold but also its quality (this means a preference for equity, which has proved much better at absorbing losses during the crisis than hybrid securities or junior debt); and (ii) the distinction between micro-prudential and macro-prudential regulation, and in particular the need to make the banking system safer against negative macroeconomic shocks (e.g. through the counter-cyclical capital buffer).

5 On the other hand, the current "bailout fatigue" has now led to a "bail-in fashion", with a desire to vastly enlarge the set of bank claim holders who are meant to be "held responsible" in the case of resolution, regardless of whether or not we are facing systemic stress.

This paradox can be explained by the fact that politicians and the general public do not feel that Basel III has required banks to hold sufficient capital to protect taxpayers from bailouts. While this feeling is probably right, one should however be careful to ensure that the envisaged solution, namely bail-in, does not lead to an even bigger cost for the taxpayer, which could easily happen were it to lead to financial instability. In my view, this is a particularly relevant concern in relation to the EU and its recently approved Banking Recovery and Resolution Directive (BRRD).

In order to comment on this Directive, let me start with four quotes from answers to Frequently Asked Questions on the EU Commission website (See European Commission, 2014):

"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 circumstances 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 available after the bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities and would be subject to the applicable rules on State Aid."

"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."

"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."*

"Depending on their risk profile, complexity, size, interconnectedness, 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."

As illustrated by these quotes, the BRRD:

6 insists on a bail-in of 8% of a bank's unweighted balance sheet (including equity), even under "very extraordinary systemic stress", as of 1 January 2016;

7 beyond secured liabilities, exempts from bail-in only very short-term debt, that is, with remaining maturity of up to seven days;

8 respects the priority of claims in bankruptcy, except that it introduces a priority for natural persons and SMEs over other senior debt holders;

9 at this point, does not impose hard targets for bail-in-able securities (called MREL, or minimum requirements for own funds and eligible liabilities in the BRRD; the Financial Stability Board talks instead of GLAC, or gone-concern loss absorbing capacity) as a percentage of bank balance sheets.

The first point reflects the political attractiveness of preventing bailouts under all possible circumstances. Note, however, that 8% of (unweighted) bank balance sheets is a sizable number, if you compare it with the 3% leverage ratio (even if the latter does take some off-balance sheet operations into account, so that it could well amount to, say, around 3.5% of straight bank liabilities for a typical bank). And 1 January 2016 represents a very short transition period, when compared to the deadlines applicable to the two solvency requirements (the capital ratio and the leverage ratio) and the two liquidity requirements (the LCR and the NSFR).

Of course, the BRRD does include attempts to counter the risk of financial instability that a bail-in could entail. This is why the second point exempts from bail-in securities whose remaining maturity is shorter than seven days. This extremely short maturity reflects a reluctance to enlarge the set of bank liabilities that would de facto become explicitly insured. Note however that this can create an incentive for banks and their depositors to favour, next to secured funding, very short-term funding, which is exactly what the LCR is trying to avoid. And, by granting retail deposits a priority over other senior debt holders, as stressed in the third point, one is in fact raising the risk faced by those depositors who typically "run faster", as the calibration from the LCR stress scenario underscores.

Those considerations explain the fourth point, which invites EU supervisors, the EBA and the European Commission to require banks to hold a "sufficient" amount of bail-in-able securities. I think this is really crucial to ensure financial stability. More specifically, I think that it would be highly desirable to require a minimum of 8% of long-run junior liabilities (equity, hybrids and junior debt) in order to foster financial stability.

Table 1 considers the very simple example of a bank without off-balance sheet operations whose liabilities have been normalised to 100. Assume a situation of "very extraordinary systemic stress" where authorities think a bailout of this bank is the best way to deal the situation, and in particular to limit eventual taxpayer losses. Under the BRRD, such a bailout cannot occur before 8% of the balance sheet has been bailed in. Where will this 8% have to come from?

Table 1

Secured + very short-term liabilities	25.0
Retail deposits	40.0
Other bail-in-able senior liabilities	30.0
Junior liabilities	1.5
Capital	3.5
Total liabilities	100.0

For this bank, equity and junior liabilities will serve as the "first line of defence", and will absorb losses of up to 5% of the balance sheet. The remaining 3% will have to come from the 30% of the balance sheet called "other bail-in-able senior liabilities". Indeed, in this example, 25% of the balance sheet is explicitly exempted from bail-in.[3] Moreover, retail deposits enjoy priority over these other bail-in-able senior liabilities, and they do not have to contribute to reach the 8% that is needed: a 10% loss shared equally

[3] For simplicity, we count in this 25% only the value of the collateral of the secured debt.

among all these "other senior liabilities" will be required before a bailout can be considered, since 3/30 = 10%.

"Spreading the pain" across 35% of the bank's claim holders does involve financial stability risks, especially with volatile wholesale deposits (some of which have a remaining maturity as short as eight days). In this case it would be safer to require the bank to hold – as well as 3.5% of its liabilities as equity – 4.5% of its balance sheet in the form of long-term junior liabilities. The crisis told us that equity was the best claim as far as loss absorbency is concerned. This is so for two reasons: (i) equity is the most junior of all claims, being therefore fully loss-absorbent before other claims start being at risk; and (ii) equity is "stuck" in the bank, and therefore cannot "run away". These two reasons make junior long-term debt (and hybrids) the next best claims. And while one could object and argue that there may not be enough of a market for these claims to satisfy the 8% requirement by 1 January 2016,[4] one must face the fact that "including" senior claims in an 8% MREL requirement is in a sense irrelevant because it does absolutely nothing to protect the other senior bail-in-able wholesale claim holders, due to the proportional burden-sharing rules applicable in resolution. Finally, let us stress that the point is not to say that senior claims should never faces losses, but simply that there could be systemic stress situations where it might make sense to allow authorities to decide between imposing such losses or going for a bailout.

3 Conclusion

Current aversion to bailouts is perfectly understandable: the crisis has been very costly to the taxpayer, and bailouts do create significant moral hazard.

One should not forget, however, the cost of financial instability: the costliest bank failure for taxpayers in the last ten years was the failure of Lehman Brothers, despite the lack of a bailout, while some bailouts, such as the Troubled Asset Relief Program (TARP) in the United States, have almost been fully repaid (more than USD 400 billion out of USD 428 billion as of May 2013 for TARP)[5]. And while part of the cost of the Lehman collapse resulted from the fact that it came as such a surprise, one should remember that "orderly" resolution will not prevent depositors from running if they can and feel their money is at risk.

Financial stability considerations therefore make a case for requiring banks to: (i) hold sufficient liquidity buffers, and (ii) hold sufficient long-term junior claims to absorb bail-in, in order to reassure senior claim holders. Such requirements will in turn help central banks by limiting the need for their lender-of-last-resort function.

4 References

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[4] Especially since financial stability considerations make it desirable for banks not to hold one another's junior liabilities.

[5] For more on the relative costs of bailouts and financial instability, see, for example, Dewatripont (2014).

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