The Banking Crisis and Its Responses

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Outline

- A brief history of (de)regulation
- Bailouts and reregulation
- The BRRD and financial stability
- Trading off insurance and incentives
- Conclusion

(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').

Assessment of (long-run) deregulation

- Interest rate and entry deregulation did benefit customers (but see *Philippon*, 2015), but at times at expense of financial stability.
- Mixed picture at best w.r.t. innovation (e.g. ATMs vs very complex new financial products), and w.r.t. size and scope (are big (universal) banks profits and high management wages due to scale/scope economies or to market power and 'too-big-to-fail' subsidy?).
- On the other hand, (Basel I/II) solvency (and liquidity) in 2008 clearly insufficient.
- Problem of both capital ratio level and banks' ability to 'manage' it (internal models, securitization, …).

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 ...).

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.
- Useful avenue: German law making senior bank bonds junior to deposits.

Trading off insurance and incentives

(*Dewatripont-Tirole* 1994a, 1994b, 2012)

Regulation as an incentive scheme

- Idea of optimal capital structure: when firm performance bad, risk for management that control switches from (nicer-to-managers) equityholders to (tougher-to-managers) debtholders.
- Representation hypothesis: in banks, debtholders unable to exert control, so see bank regulation as a way to replicate role of capital structure in non-financial corporations.
- In a sense, Basel regulation does achieve this, provided that control switch is credible (resolution question).

Regulation as an incentive scheme (2)

- Key issue however: which performance?
- Answer: idiosyncratic performance, not performance linked to aggregate shocks (*Holmstrom*) !
- This issue was ignored by Basel I: bank capital requirements became stricter in recessions.
- Attempt to ‘ignore’ the problem through accounting changes was NOT a good idea.
- Procyclicality was made worse by Basel II, when negative macro shocks led to ratings downgrades, in the standardized approach, or internal model parameter revisions.

Regulation as an incentive scheme (3)

- Macro issue addressed to some extent by Basel III: counter-cyclical capital buffer (similar to Spanish dynamic provisioning), but also capital conservation buffer, and even LCR, also meant to serve as a buffer.
- One problem though: this is only ‘self-insurance’, e.g. CCyCB works provided bad shock ‘follows’ good one, so that there is a buffer to be released !
- Additional problem: will buffer be ‘released’ in case of need? Otherwise, becomes a ‘requirement’, clearly suboptimal in the case of the LCR (Good-hart taxi line problem).

Regulation as an incentive scheme (4)

- Better to introduce capital insurance (à la *Kashyap-Rajan-Stein*), probably State-provided (has to be credible: remember AIG …), or other forms of automatic stabilizers (e.g. through taxes, resolution premia, deposit insurance premia, … indexed on the business cycle).
- Based on the idea of the State as insurer of last resort (classical in economics).
- Such rule-based macroprudential stabilizer can be attractive as complement to (not-easy-to-implement) discretionary macroprudential policy (many tools, many actors).

Regulation as an incentive scheme (5)

- Instead, BRRD seems to be based on ‘protecting the taxpayer as much as possible’: OK for idiosyncratic shocks, NOT for macro shocks !
- One way to make BRRD consistent with this micro/macro distinction: have banks issue CoCos whose triggers would distinguish between idio-syncratic and macroeconomic events, so as to appropriately discipline bank management.
- Not easy to design though (but see *Bulow-Klem-perer* on the CoCo debate). Why not complement it with additional insurance mechanisms?

Conclusion

- Search for optimal tradeoff between productive efficiency, financial stability and fight against moral hazard continues.
- At this point, ‘protecting taxpayers’ is given priority.
- Don’t forget however the cost of financial instability, while there have been successful bailout experiences in case of macro crises.
- Therefore, do at least design bail-in a way that will not trigger bank runs.
- Do complement it with capital insurance against macro risks and/or other automatic stabilizers.

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