The Dark Side of Bank Resolution: Counterparty Risk Through Bail-In

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Bail-in: significant post-crisis achievement in ending “too big to fail”

Key idea: impose losses on creditors instead of taxpayer

But serious uncertainties remain

- Adjustments may be necessary: credibility of using bail-in powers / trigger requirements (Ringe 2018)
- Liquidity provision during resolution (Ringe 2018)
- Effects may be counterproductive: blind eye to “who holds” bail-in debt (Ringe & Patel 2019)
Bail-in

Ringe & Patel 2019

Motivation of this paper:

- The risk doesn’t disappear
  - Who are bail-in counterparties? = who holds bail-in debt?
  - Who should be ideal counterparties?
- Might perverse incentives lead banks to hold (bail-in) debt in each other? (to increase contagion?)
Study effects of bail-in introduction in EU

- De facto 1 January 2016
- Bail-in section of BRRD comes into force
- Single Resolution Mechanism (SRM) as part of Banking Union enters into force
- Intergovernmental Agreement on Single Resolution Fund (SRF) comes into force
Data from ECB Securities Holdings Statistics (SHS)

- details total values of assets held by types of holders, defined by regulatory supervision structures
- Data covers “Monetary Financial Institutions” (MFIs)
- Quarters 4/2013 to 3/2018

- Supports claim that bail-in is catalysing Eurozone banks’ interconnectedness.
- EZ bail-in date
- Eurozone banks
- Interconnectedness proportions changed direction
- Increasingly interconnected
Comparison: MFI holdings of other MFIs & Non-MFI holdings of MFIs

MFI:MFI Long Term Debt

NonMFI:MFI

MFI:MFI Short Term Debt

MFI Holdings of MFI Long Term Debt
MFI Holdings of MFI Short Term Debt
MFI Holdings of MFI Investment Fund Shares
Non-MFI Holdings of MFI Securities
MFI Holdings of MFI Listed Shares

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficients Model 1</th>
<th>Coefficients Model 2</th>
<th>Coefficients Model 3</th>
<th>Coefficients Model 4</th>
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<td>Intercept</td>
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<td></td>
<td>(0.05419)</td>
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<td>Asset Purchase Programme</td>
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<td>(0.02201)</td>
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<td>Rate of decrease of Bank Entities</td>
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<td>(0.63804)</td>
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<td>Interest Rates</td>
<td>-0.03156</td>
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<td>(0.18012)</td>
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<td>Bail-in? (Time)</td>
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<td>(0.00984)</td>
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<td>MFI Interconnections? (Treatment)</td>
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<td>Interaction (Difference in Differences)</td>
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Bail-in laws incentivise bank interconnections

**Interconnections preferred by banks**

- more **robust** to small shocks (Freixas, Parigi, and Rochet, 2000; Allen and Babus, 2009; Acemoglu et al., 2015; Hüser et al, 2018).
- higher likelihood of bail-out, because **bail-in frustrated** by systemic risk it creates (Bernard, Capponi, and Stiglitz, 2017)

-> through bail-in, banks have **relative advantage** in investing in other banks’ capital

-> less (systemically) costly for banks, than for non-banks, to invest in other banks
Regulation: What can be done about it?
Prescriptions are dysfunctional

Lack of knowledge:

- Matching topology with shock type
- How bank interconnections affect systemic risk.
- Do not know if bail-in decision is false positive.

Core: We take a prescriptive approach, but we don’t know what the prescription should be.
Prescriptions are dysfunctional

Basel III & CRR/CRD:

- Deductions affect capital count (ex-ante), but not necessarily bail-in determinations (ex-post). Therefore the deductions’ ‘deterrence’ is not strong enough or it is insufficiently matched.
  - The data! - deductions are binary / monotonic in approach, but matching between shock and topology is non-monotonic.
  - Separately: indirect or opaque holdings, including custodians and SPVs?

- Prudential regulation and heterogeneity trade-off – supervisors impose views and herd investment behaviour (Bernanke, 2013), and regulators may be incentivised to bias bail-outs (Farhi and Tirole, 2012).
Instead: Coasian Style Suggestions

Knowledge, portfolios, internalisation, co-operation

• Portfolio management – Not regulator type.
• Drilled down SHS data (entity level)
• IFRS 9 as a default reporting, with comply or explain approach
• Remove the legal “contagion” exemption & signal intent to resolve multiple entities simultaneously
• Pigouvian tax for *any* increasing interconnections amongst major financial institutions
Summary

• bail-in may increase (rather than reduce) systemic risk through banking interconnections
• relative advantages for banks that invest in other banks: bail-in framework does not internalise systemic risk costs that arise out of counterparty selection
• challenge of bail-in functioning within the complexity of its objectives
• optimal systemic risk internalisation may be impossible
QUICK! GIMME THE CASH!
Professor Georg Ringe and Jatine Patel

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Full paper available at https://ssrn.com/abstract=3314103