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FAKULTÄT
FÜR RECHTSWISSENSCHAFT

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THE DARK SIDE OF BANK RESOLUTION: COUNTERPARTY RISK THROUGH BAIL-IN

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Overview

- 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?)

Bail-in

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

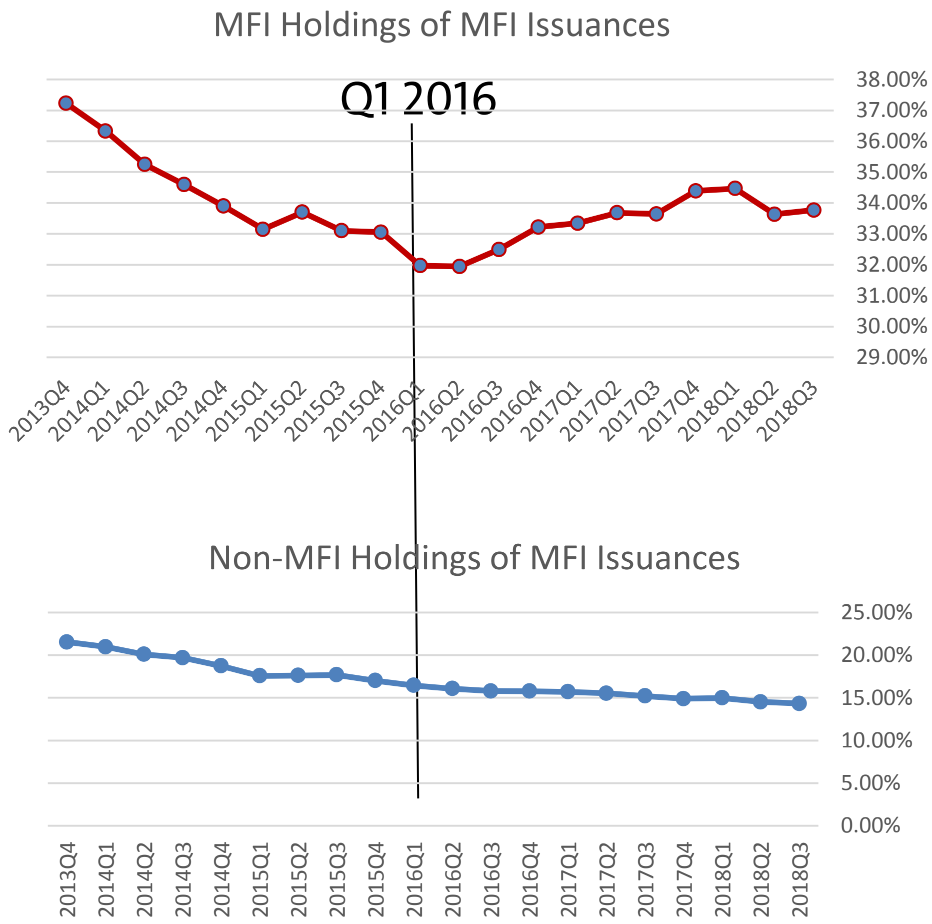
Bail-in

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



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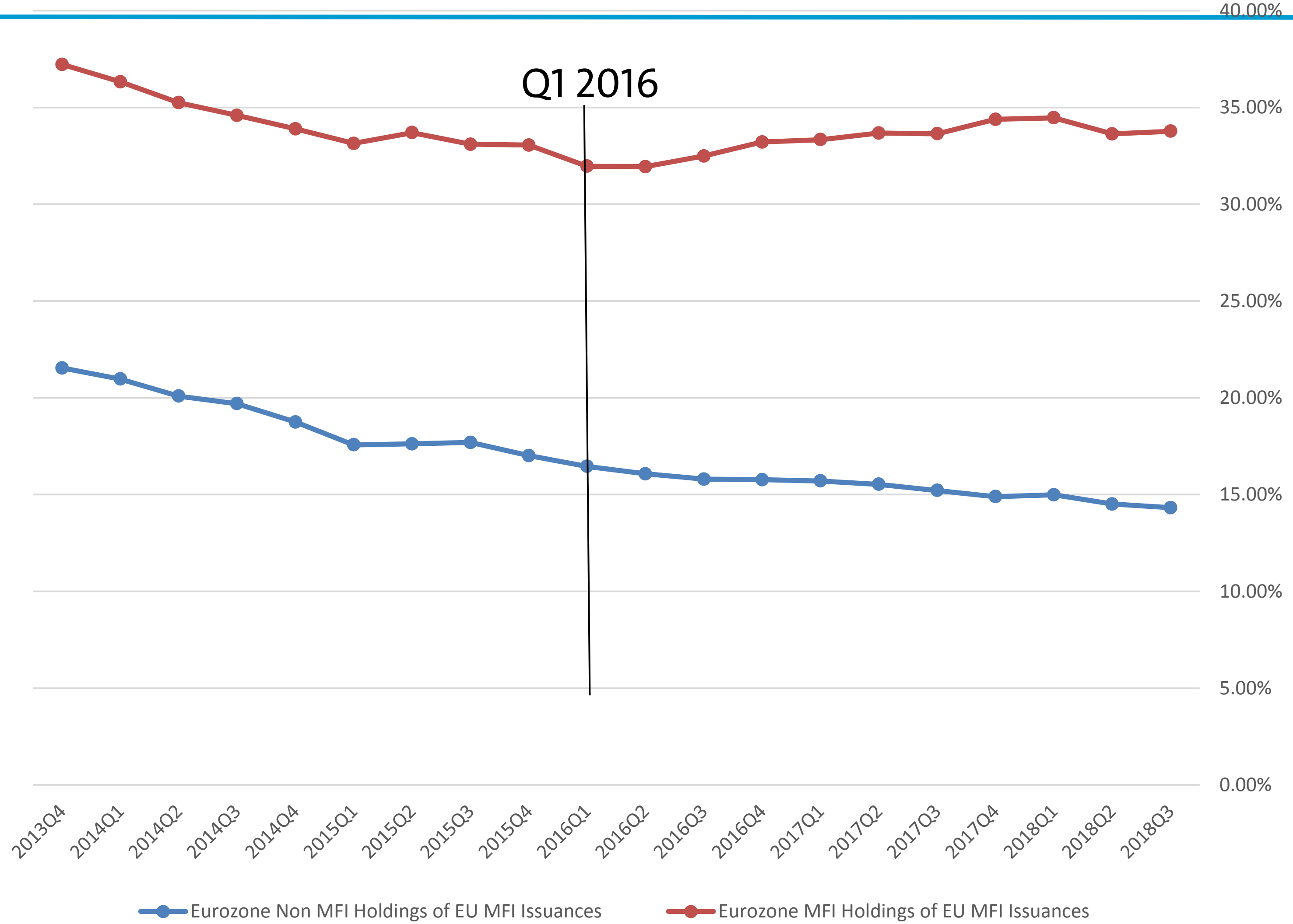
Bank Interconnectedness



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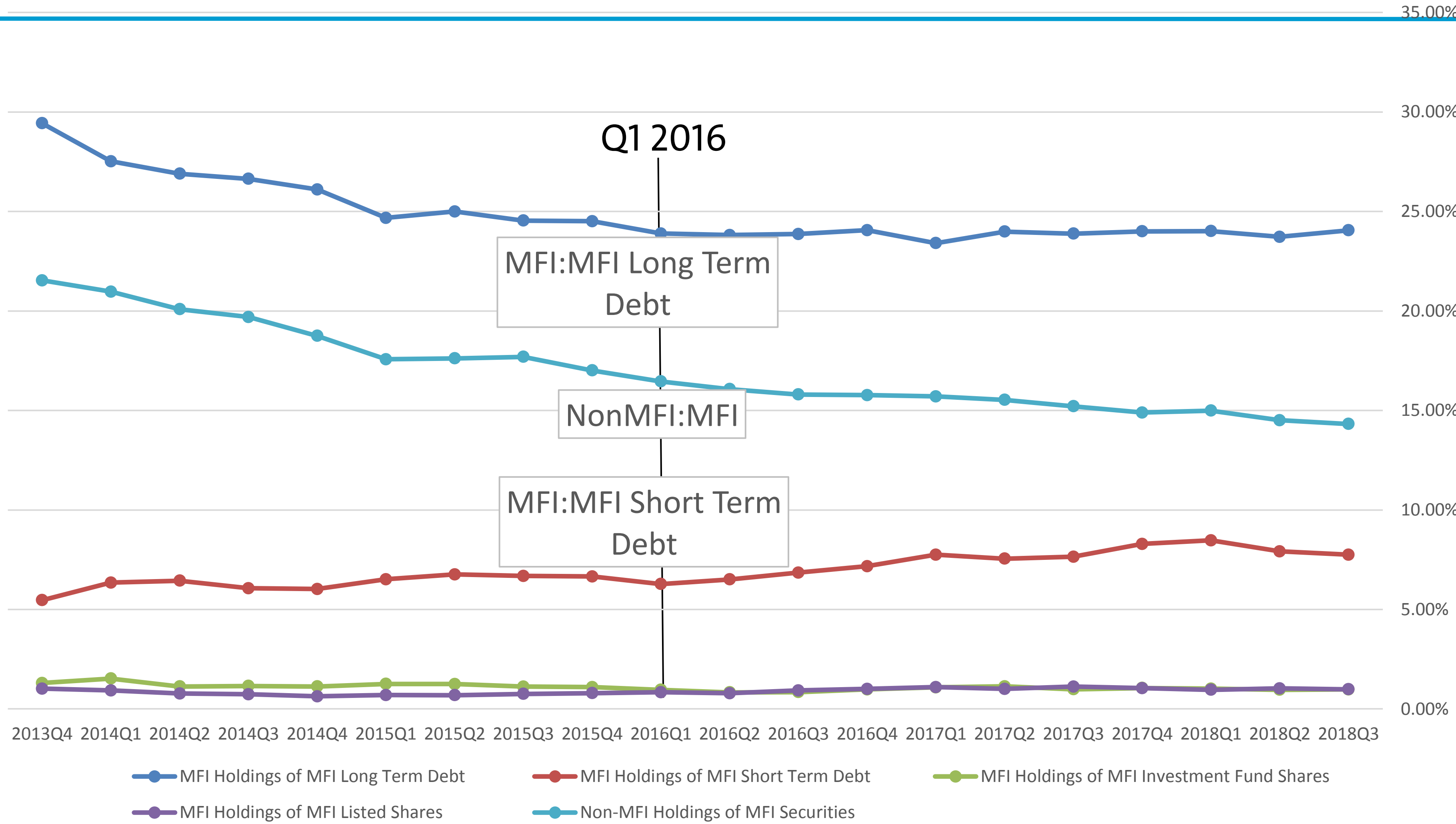
Comparison: MFI holdings of other MFIs & Non-MFI holdings of MFIs



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Variables	Coefficients Model 1	Coefficients Model 2	Coefficients Model 3	Coefficients Model 4
Intercept	0.19939	0.19840	0.07876	0.01464
	(0.05419)	(0.05509)	(0.06163)	(0.04525)
Asset Purchase Programme				-0.00001***
				(0.000001)
Bank Index			0.07021	0.05441
			(0.02201)	(0.01591)
Rate of decrease of Bank		-0.15052	-0.65729	0.62563
Entities		(0.63804)	(0.58811)	(0.47417)
Interest Rates	-0.03156	-0.03008	0.35962	0.62579
	(0.18012)	(0.18271)	(0.20303)	(0.15171)
Bail-in?	-0.03748	-0.03747	-0.01729	-0.00937
(Time)	(0.00984)	(0.00998)	(0.01088)	(0.00787)
MFI Interconnections?	0.15483	0.15483	0.15483	0.15483
(Treatment)	(0.00572)	(0.00580)	(0.00515)	(0.00367)
Interaction	0.02451***	0.02451***	0.02451***	0.02451***
(Difference in Differences)	(0.00772)	(0.00783)	(0.00694)	(0.00494)
Observations	40	40	40	40
R Square	0.98254	0.98256	0.98667	0.99345

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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

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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.

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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

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Conclusion

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


BANK
QUICK! GIMME THE CASH!

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