Can post-crisis regulation help mitigate the risks created by systemic institutions?

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Abstract:
The 2008 crisis was marked by large-scale government interventions to rescue systemic institutions.¹ Injections of capital to some institutions have increased public deficits and, although they curtailed the impact of systemic shock, they fostered moral hazard. Systemic financial institutions are defined here as institutions with a "systemic impact", that is, those whose difficulties or even failure could cause the failure of other institutions or have a negative impact on the real economy.² In the immediate post-crisis period, under the impetus of the G20, a financial reform programme was launched, the results of which are presented here. This paper focuses on two aspects of the reform: regulation of the activity of systemic institutions to limit their impact on the financial system and implementation of measures facilitating the resolution of systemic institutions.

Regulating the activity of systemic institutions

After the Basel III reform, one of the first areas addressed by the post-crisis financial reform was improved regulation of systemic institutions' activity. After a recap of the approach adopted to identify them for the purpose of subjecting them to tighter supervision, we will present an initial assessment of their impact.

Identification by supervisory authorities

In the banking sector

Systemic banking institutions (or "G-SIBs" - Global Systemically Important Banks) are subject to more intrusive supervision, enhanced disclosure requirements, and additional capital requirements. Increasing the cost of capital compensates for the financing premium from which too-big-to-fail (TBTF) or too-interconnected-to-fail institutions benefit. It is also about ex ante contributions to the cost of a possible bailout, as well as reducing the likelihood of bankruptcy by increasing loss absorption capacity.

¹ According to the FSB, systemic banks (excluding Lehman Brothers, Bear Stearns and Wachovia) suffered losses of up to 5% of their total assets, with half in the 2-4% range. According to the European Commission, average losses over the period 2007-2010 reached 3% of assets.
² They are to be distinguished from systemically "fragile" institutions, i.e. those likely to fail in the event of other banks' difficulties.
Haldane (2010) compares the ratings given by rating agencies to institutions that are likely – in case of difficulties – to receive public support and those given to standalone ones that will not. He notes that the rating gap is significant, particularly for larger institutions, and that it increases during the crisis. Haldane estimates that the five largest UK banks received an implicit annual subsidy of £50 billion between 2007 and 2009. Based on a large sample of major international banks, Ueda and Weder di Mauro (2013), estimate this subsidy in terms of savings made by issuers on their borrowing terms at 60 basis points at the end of 2007 and 80 basis points at the end of 2009.

The FSB’s identification of systemic banks at global level is based on criteria that include size, interconnections, non-substitutability, complexity and cross-border flows, using accounting data.

In addition to the size of establishments, which is an important criterion, regulation aims to limit activities that can induce contagion effects. The IMF’s efforts have revealed that the pre-crisis period was marked by a sharp uptick in unregulated cross-border operations. For banks operating in the euro area, however, there are arguments for considering that, given the progress of European integration (single monetary policy, supervision and resolution), intra-euro area trade should no longer be considered as cross-border flows. In this respect, Faia et al (2017) demonstrated that, unlike the pre-crisis situation, the internationalisation of European G-SIBs after the crisis tended to reduce risk, at the individual and systemic level, due to better diversification, and was not associated with regulatory arbitrage.

In the insurance sector

An identical approach to identify systemic insurance institutions was put in place by the FSB starting in 2013, taking into account the specificities of insurance. The approach emphasizes the weight of "non-insurance and non-traditional" activities. It is more controversial, however. On the one hand, reinsurers are excluded from the analysis, and on the other, identification has no impact on capital requirements due to the absence of a common international capital standard. In addition, AIG was removed by the US authorities from the list of systemic insurers at national level in September 2017 and Metlife appealed the decision to the courts. Currently, efforts are being directed towards analysing the systemicity of activities rather than institutions (an activity-based approach instead of an entity-based approach), which has the advantage of being more consistent with analyses of asset management systemicity. There is also the issue of comparability of criteria between banks and insurance companies.

\[^3\] A similar approach was used to identify systemic institutions at national level.\n
\[^4\] See de Bandt et al. (2015) for an analysis of the strengths and weaknesses of systemic risk indicators.
Impact on the behaviour of G-SIBs

To date, few studies have assessed the impact of these reforms. Since the crisis and the ensuing bankruptcies, concentration in the banking sector has increased. Although a more concentrated system can increase market power and the risks associated with TBTFs, it allows – at least initially – for better risk-sharing. But this trend occurred only in the United States: the share of the five largest banks rose from 40% of bank assets in 2006 to 63% in 2016, while in the euro area it remained between 18% and 20%, i.e. below the level of the US pre-crisis. This is the reflection of a margin in terms of concentration of European banks in the form of cross-border mergers and thus better risk-sharing within the euro area.

Durant et al. (2018) provide the most comprehensive review of G-SIB reforms. On the basis of a study of international banks likely to be classified as G-SIBs, and employing a rigorous methodology (the "difference in differences" approach, or DID), they show that the implementation of the G-SIB framework led to a decline in total assets managed by systemic banks at aggregate level (Chart 1). On an individual level, it curbed the expansion of the G-SIBs balance sheets, without leading to a drop in lending to the economy. Nevertheless, the authors note that these banks still have access to lower-cost financing compared to other banks, suggesting that the regulation has not eliminated implicit public support for these banks.

Source: Durant et al. (2018).
Resolution of systemic institutions

The second major part of the post-crisis reforms dealing with systemic financial institutions is the introduction of new instruments to manage their potential failure. Although resolution concerns more than systemic institutions – particularly in Europe where the crisis has mainly affected medium-sized banks – the treatment of G-SIB difficulties has played an important role in the new post-crisis resolution framework. In November 2011, the FSB set out the basic principles for organising the bailout or liquidation of financial institutions in difficulty ("Key Attributes of Effective Resolution Regimes for Financial Institutions"), and in 2015 it called for an increase in the capacity to absorb losses through receivables ("TLAC term sheet").

We will look at the objectives, means and effects of these reforms.

New objectives

The failure of Lehman Brothers and the public bailouts in 2007-2008 revealed the need for better management of banks whose bankruptcy could have a systemic impact. There were several goals:

Respond to crisis situations by empowering a resolution authority to maintain financial stability

• In times of crisis, rescue or liquidation of financial institutions by the courts alone is not the most effective course of action. A bailout or restructuring plan sends a negative signal to the market about the institution's financial health, making it even more difficult to rescue. The crisis also showed that subordinated debt had not played a supplementary defensive role in absorbing losses.

• Conversely, the reforms assign a larger role to an administrative authority with power in terms of resolution. This is also true for the FDIC, which had experience in managing small bank failures, but whose resolution powers were strengthened by the Dodd-Frank Act of July 2010 (Title II). Similarly, in the EU the Bank Recovery and Resolution Directive (BRRD), which was adopted in May 2014, led to the establishment of the Single Resolution Board (SRB) and the various national resolution authorities.  

• A resolution authority may transfer assets to a bridge bank against creditors' wishes. Its powers may include the possibility of a bail-in by creditors, the ability to exclude (or not) certain types of debt from the bail-in. It can dictate the scope of the bail-in, distributing liquidation costs across a wider group or focusing its impact on a small number of creditors.  

Protecting depositors, including depositors not covered by a guarantee mechanism, is one of the resolution goals introduced by the BRRD. Nevertheless, these powers are regulated,

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5 In France, pursuant to the Act of 26 July 2013, the Prudential Supervisory Authority (ACP) became the Prudential Supervisory and Resolution Authority (ACPR).

6 Short-term deposits, derivatives transactions cleared in CCPs and liabilities with respect to payment systems are generally excluded from bail-ins. Deposits not covered by depositor insurance are bail-inable in the EU (as was the case during the Cyprus crisis in March 2013, but prior to the entry into force of the BRRD).
under the supervision of the judge who assesses whether the rights of creditors are being upheld (in the event of a resolution, creditors must not be treated less well than in the event of a liquidation).

**Protecting public finances by involving creditors**

This objective became all the more necessary since, during the crisis, public finances were heavily mobilised. Interventions were all the more costly because there was no effective procedure for managing systemic institutions and involving private creditors. During the European crises, Philippon and Salord (2017) estimate that taxpayers financed two-thirds of recapitalisations.

The reforms introduced provisions limiting the use of public finances. In the BRRD, a government bailout is only possible if private creditors have contributed 8% of the liabilities of the bank in difficulty. The public authorities' contributions in terms of financing are regulated in the BRRD. They are subject to the State aid regime which is supervised by the Commission. In the US, government intervention excludes equity participation, only loans and guarantees are allowed.

**Defining specific measures for institutions identified as G-SIBs**

In the US, the enhanced resolution powers of the FDIC apply only to institutions that the Treasury has identified as systemic. At international level, the supplementary requirements in terms of total loss-absorbing capacity (TLAC) by capital and eligible debt primarily focuses on G-SIBs. The European Union has nevertheless decided to transpose this measure for all banks in the form of a MREL (Minimum Required Eligible Liabilities) requirement. In all cases, it involves defining an additional buffer of debt securities that will be able to absorb the losses if the capital is not sufficient. In the case of Europe, the basic requirements of G-SIBs are defined in Pillar 1, while those of other banks are defined only in Pillar 2.

**Specific conditions in the United States and Europe**

The core principles of the FSB's key attributes are currently complied with by the EU via the BRRD and by the United States as part of the DFA, although the US administration is considering some changes. However, there are some specificities; these include, in particular:

- The European resolution mechanism is more flexible since it allows resolution at the level of a single point of entry (SPE) or multiple point of entry (MPE), which offers more leeway for resolving cross-border groups, whereas the DFA focuses on the SPE at the level of bank holding companies (BHCs).

- European resolution authorities establish both resolution and recovery plans, while US banks only provide “living wills”.

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7 For a detailed analysis of resolution mechanisms in the United States and Europe, the reader is referred to Philippon and Salord (2017).
• The resolution authority in the US does not have power in terms of bail-ins, but the creation of a bridge bank can have the same effect.

• At present, unlike the US, the lack of a single Treasury within the euro area limits the available financial resources. But the Single Resolution Fund could be backstopped via the European Stability Mechanism (ESM) or other mechanisms.

Results and achievements of the resolution reforms

It is too early to take stock of the initial experiences in terms of resolutions and the use of bail-in tools. But in relation to the expected effects, there are definite areas for improvement.

*Expected economic impact*

For the BIS (2015), these reforms have the effect of lessening:

• The probability of a crisis, due to a drop in risk-taking (the economic literature suggests a one-third reduction in crisis probability\(^8\)), and

• The cost of crises due to more effective crisis resolution, thanks to the new resolution mechanisms.

The new resolution rules will increase the financing costs of international banks, but by how much? According to the BIS (2015), based on the experience of the US, the impact would be small, but this partly depends on creditors' expectations in terms of public support, which remains high.

*Areas for improvement*

There are three possible paths:

• If we adopt a more global perspective, the final holding of bail-inable securities by other financial institutions may create a channel for contagion. For this reason, as for the treatment of equity capital, the Basel Committee decided to deduct the holding of securities included in the TLAC from Tier 2 liabilities. Similarly, the European authorities have stated their opposition to private individuals holding bail-inable securities.

• Bail-ins cannot solve every problem, and public funding may remain necessary in the event of a systemic crisis.

• In the case of cross-border groups, resolution implementation presupposes an alignment of interests between the home country of the ultimate parent and the host country of international banks' subsidiaries. In this regard, large subsidiaries must also meet

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\(^8\) Santos *et al.* (2015) show that the increased probability of public support leads to risk-taking and to a deterioration in loan portfolio quality.
TLAC requirements and, as part of the BRRD review, ultimate parent companies may be required to subscribe to subordinated debt issued by their subsidiaries.

In conclusion, significant progress has been made in regulating systemic institutions, which ensure risk diversification but can also have an impact on financial stability. As regards resolution, there has been significant international harmonisation, although insolvency proceedings and the hierarchy of creditors within the EU remain heterogeneous. In the insurance sector, although the FSB deprecates delays in terms of resolution management, in France an order creating an insurance resolution scheme was adopted on 27 November 2017.

References


