Bail-in: a regulatory critique

This short article discusses some of the legal and market risks in using the bail-in resolution tool, as it is defined and applied in the EU Bank Recovery and Resolution Directive. The BRRD’s bail-in tool provides resolution authorities with wide discretion to impose losses on the creditors and shareholders of a distressed bank while it is a going concern. The article argues that the rules governing when and how resolution authorities can use the bail-in tool are vague and provide inadequate guidance for market participants. The bail-in tool represents an ad hoc regulatory measure that undermines market confidence and potentially infringes on fundamental property rights under EU and ECHR jurisprudence.

The G20 and Financial Stability Board (FSB) embarked in 2009 on an ambitious programme of international regulatory reforms designed to enhance regulatory controls against financial risks that threaten the stability and integrity of the financial system. These regulatory reforms have led, among others, to stricter bank capital and liquidity requirements, the mandatory clearing of OTC derivatives in clearing houses, and bank resolution requirements that allow authorities to impose losses on bank creditors through the use of the “bail-in” tool. The FSB’s 2014 Key Attributes of Effective Resolution Regimes for Financial Institutions stipulates that authorities should be able to impose losses on bank creditors before taxpayer funds are committed to bailing out or subsidising the recovery of a distressed institution. The European Union has implemented this international mandate by adopting the Bank Recovery and Resolution Directive (BRRD) that became effective on 1 January 2016. The BRRD introduces into EU law the use of discretionary resolution tools enumerated in Art 37 (3), namely, the sale of the business tool, the bridge institution tool, the asset separation tool and the bail-in tool. Resolution authorities may execute the resolution tools individually or in any combination.

The design of the BRRD bail-in tool involves regulated institutions issuing minimum amounts of loss-absorbent capital (mainly unsecured bondholders) without clear guidelines and concrete criteria. The bail-in tool is a response to one of the main causes of the financial crisis of 2007–09 that banks and other institutions had not engaged in adequate resolution planning with the result that when markets froze in late 2007 and again in 2008 public authorities had no mechanism outside of a formal restructuring or insolvency for allocating losses to an institution’s creditors when it was in financial distress. Although the experience of the last crisis in Europe has led policymakers to adopt resolution tools that are designed to address the particular types of risks that caused the last crisis, it is questionable whether these tools will be effective in addressing the fallout from the next crisis. This article discusses some of the regulatory risks in using bail-in, as it is defined and applied in the BRRD, to impose losses on bank creditors and thereby limit the taxpayer’s direct financial exposure for having to bail out a systemically important institution.

THE PROBLEM WITH AD HOC REGULATION

After a financial crisis, policymakers naturally want to prevent the next crisis. Regulators, who are themselves usually subject to political short-termism, typically respond by focusing on ex ante preventative regulation, or at least regulation aimed at preventing the next financial crisis. But that focus is insufficient because it is impossible to always predict the cause of the next crisis. Indeed, although panics are often the triggers that commence a chain of systemic failures, it is impossible even to identify all the causes of panics. For these and other reasons, policymakers and regulators often take an ad hoc (and thus unsystematic) approach to regulation, viewing financial regulation as a collection of ideas. Each of the ideas might make sense in some context; collectively, however, the ideas might not yield a coordinated regulatory framework. Thus, as shown below, regulators and policymakers generally view macroprudential regulatory measures as a loose assortment of “tools” in their “toolkit”.

This ad hoc approach results in either overly specific regulatory proposals without realistic guidance as to their application or use, or overly broad propositions that provide no concrete regulatory guidance at all. As an example of overly specific regulatory measures, the “emergent macroprudential ‘toolkit’ as currently constituted” aims to limit the growth of leverage across financial sectors, to enhance capital buffer requirements, minimum liquidity requirements, limits on maturity mismatches, dynamic countercyclical provisioning, and surveillance and data collection. As an example of overly broad regulatory measures, the European Union’s adoption of the Bank Recovery and Resolution Directive provides authorities with a choice of several resolution tools to ensure that an institution can fail safely during periods of market distress. Although this litany of “tools” represents a range of diverse approaches, the BRRD provides no guidance as to which “tools” should be used in which circumstances, or as to how they should be calibrated.

As discussed below, the misapplication of these tools – such as imposing losses on certain groups of bondholders but not others – without providing any concrete guidance in advance as how losses would be allocated and to what extent they would be imposed, could potentially create substantial moral hazard in the financial system and may be as likely to cause or exacerbate financial problems, as solve them.
Bail-in
Bail-in provisions are intended to address the moral hazard problem of so-called too-big-to-fail financial institutions and the unfairness of having taxpayers subsidize excessive private sector risk-taking. It is submitted that bail-in provisions that result from unsystematic financial regulation could, however, have unintended consequences. The BBRD possesses a bail-in tool, in which creditors and shareholders of a distressed financial institution must ‘suffer appropriate losses and bear an appropriate part of those costs arising from the failure of the institution … [to] give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances’. The bail-in provisions include replacing management at the failing institution, and implementing a ‘restructuring plan’ as compatible as possible with the plan submitted by the corporation prior to its failing. For example, the use of the ‘bail-in’ tool affords authorities vast discretion to member state competent authorities in how they exercise their powers – and other fundamental legal rights – in order to achieve regulatory or other public policy objectives must conform with the proportionality principle under EU law (interpreted both by the CJEU and ECHR). However, the discretionary ad hoc exercise of macroprudential powers can only not potentially infringe on the fundamental rights of shareholders and creditors of financial institutions, but can also result in substantial moral hazard in the financial system that can potentially lead to financial system disturbances and even breakdown. The EU bail-in tool – although well-intended to address the inadequate resolution frameworks in place prior to the crisis – as used by EU authorities creates a number of other serious regulatory and market risks that reflect the fact that its design and application has not been thought through in a systematic way. In other words, it is an ad hoc regulatory tool that focuses more on the risks of limiting taxpayer exposure to bank bailouts than it does to create sound legal and market conditions to avoid a future crisis. Less discretion for resolution authorities in how they exercise their powers regarding which groups to impose losses on would go far in supporting legal certainty and market discipline.

3 BRRD, art 37(4).
6 Ibid, 28.
7 Ibid, 28.
8 Ibid, 30 (‘where liabilities have been excluded and the resolution fund has been used to contribute to bail-in in lieu of these liabilities up to the permissible cap’).
9 Ibid, 145145 (the alternative arrangement ‘shall be conditional on prior and final approval under the State Aid rules’).
10 Ibid. 145.
13 See I Anabtawi & Steven L Schwartz, ‘Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure’ (2013) 92 TLR 75, 117 (making this same observation about contingent equity as a bail-in mechanism); Schwartz, ‘Controlling Financial Chaos: The Power and Limits of Law’ (2012) WLR 815, 837 (‘automatic conversions of debt claims to equity interests might create counterparty risk by reducing the value of firms holding those claims’).
14 H S Scott, Interconnectedness and Contagion (2012) 16, asrn.com/abstract=2178475
15 Anabtawi and Schwartz, (n 13), 118.