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All In On Bailing-In? Global Resolution Regimes Take A Mixed View

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All In On Bailing-In? Global Resolution Regimes Take A Mixed View

Following the massive bailout of banks by governments in the U.S. and Europe during the 2008-2009 financial crisis, policymakers in those markets have increasingly tied their hands to significantly reduce bailout possibilities in a future banking crisis. Such decisions contrast with developments in Asia and Latin America, where most countries are not contemplating introducing senior creditor bail-in in their resolution regime frameworks yet and are keen to keep the bailout as a valid tool for the government to manage through a crisis. Standard & Poor's Ratings Services expects greater differentiation in the way we factor government support into our ratings on banks across these regions, and we wonder about potential unintended consequences of these differences in policy.

Overview

- European and North American policymakers, in their attempt to foster greater market discipline and protect their taxpayers, have sought to legally tie their hands to limit their ability to bail out their banking systems.
- This attitude contrasts sharply with developments in Asia and Latin America, where the dominant view is that policymakers should keep the ability to bail out senior creditors, and only a minority of countries is contemplating enabling senior creditor bail-in as a tool to recapitalize a bank.
- Arguments developed in these different regions suggest that reducing crisis-management options could turn into a potential handicap, or a missed opportunity to foster greater market discipline.

With the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the U.S. and the recent adoption of the Bank Recovery and Resolution Directive (BRRD) in Europe, policymakers have made significant strides to ensure that taxpayers will not be called on again to bail out failing banks. Dodd-Frank explicitly bans the bailout of an insolvent bank and drastically limits the Federal Reserve's ability to provide liquidity support to a failing bank prior to its holding company being placed into receivership under the Federal Deposit Insurance Corp. as part of its orderly resolution authority. In Europe, the BRRD requires prior haircuts of a bank's equityholders and creditors up to 8% of adjusted liabilities and equity, or 20% of risk-weighted assets, before a potential bailout can take place. Article 32 of the directive is explicit that the government should not extend precautionary recapitalization or liability guarantees to offset losses. This means that, in the absence of a sufficiently large buffer of equity and junior debt, senior creditors may need to be bailed in prior to any bailout, no matter how systemic the institution. At the same time, policymakers are making significant efforts to put in place credible resolution plans for large systematically important banks.

We view the development of bank resolution tool kits associated with creditor bail-in as a direct answer to the recent crisis experience. The lack of resolution planning and bail-in powers was a critical gap in policymakers' crisis-management tools. In some instances, we believe such planning could have helped mitigate contagion to sovereigns. This left governments with limited alternatives other than recapitalizing banks and flooding the market with liquidity in the interest of financial stability. The absence of such plans may also have contributed to a perception of "too big to fail" and a lack of market discipline. In response, the current explicit political intent to move the burden of support from taxpayers to creditors may eventually foster greater market discipline. More and more, market

participants are now considering that even senior creditors of systemically important financial institutions could be at risk of facing haircuts. Standard & Poor's assigned negative outlooks on our ratings on eight large systemically important U.S. bank holding companies in June 2013, indicating that we may remove the uplift for extraordinary government support that we currently factor in. We took similar rating actions on European banks on April 29 because we expect to reduce or remove the uplift from government support within the next 18 months once a number of technical hurdles are removed.

By seeking to tie their hands through legislation, European and American policymakers have deliberately sent a strong message to investors not to expect public solvency support. This might be an effective way to strengthen market discipline and meet political objectives to protect taxpayers. This decision could, however, also hinder policymakers' ability to preserve financial stability in a crisis.

Beside the fact that the orderly resolution of a large, internationally active, complex bank would be technically very difficult today, policymakers on both sides of the Atlantic recognize that bank-specific living wills or resolution plans being put in place are likely to remain challenging for the foreseeable future in case of systemic crisis. Triggering a senior unsecured bail-in could have unintended consequences, if several large banks are at risk of failing at the same time. Financial stability and contagion risks could require the use of tools that policymakers are currently attempting to ban. Given the difficulty to predict the shape and timing of future banking crises and the importance of a timely response by regulators, we wonder whether restrictions on bailout tools could turn into a crisis-management handicap. Interestingly, in Switzerland, a country that is among the most far along in putting in place a resolution regime and with a clear intent to use bail-in, regulators have not explicitly excluded the bailout option.

In Asia-Pacific and Latin America, we are witnessing a different attitude. Progress in implementing Financial Stability Board (FSB) "key attributes of Effective Resolution Regimes" is uneven, and many countries are not even contemplating changing their framework to enable senior creditor bail-in. So far, we have not taken rating actions on banks in these regions to reflect the potential removal of government support. While we might reduce such support in our ratings considerations in the future to reflect incremental bail-in risk, it is less likely that we remove the uplift from government support from our ratings on systemic banks in those regions. Even the G20 Asia-Pacific countries, which are in the process of implementing FSB key attributes, do not seem ready to give up the bailout tool, at least as an available option alongside senior creditor bail-in.

Policymakers, including in Organization for Economic Cooperation and Development countries such as Australia, Japan, and Mexico, may view bailing out a failing systemic bank as often less costly than forcing senior creditor bail-in. One consideration often being made is that senior creditor bail-in could trigger contagion risks, lead to a significant reduction of funding access for their banking system, and ultimately constrain the financing of their economy. We, however, wonder whether slow progress, or lack thereof, toward putting in place resolution regimes, including senior creditor bail-in as an available option, isn't a missed opportunity to foster greater discipline and reduce the probability of future failures.

In summary, we wonder whether the U.S. and Europe might be missing an opportunity to allow future governments to choose the less costly alternative while Asian and Latin America might be missing an opportunity to foster greater market discipline.

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Related Criteria And Research

Related Research

- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
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- While Banking Union Proceeds, Sovereign And Bank Risks In The Eurozone Remain Intertwined, March 10, 2014
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