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Taking Bail-in Seriously – The Looming Risks for Banking Policy in the Rescue of Monte Paschi di Siena

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Taking Bail-in Seriously

The looming risks for banking policy in the rescue of Monte Paschi di Siena[1]

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The case of the ailing Italian bank Monte dei Paschi di Siena (MPS) constitutes the litmus test for the credibility of the new European bank recovery and resolution regime – introduced in 2014 as a lesson from the recent financial crisis. Depending on the outcome of this test-case, the regulatory strategy pursued with the Bank Recovery and Resolution Directive (BRRD) – namely having banks' investors pay for losses (bail-in) – may already collapse at the state of infancy.

It seems to us that not everyone involved has fully realized what is at stake: Only if investors in bank capital understand that the relevant authorities stick to the letter and the spirit of the BRRD, and indeed require a significant private sector involvement in the resolution of banks, will they price bank capital without considering implicit government guarantees and, thus, help to restore market-discipline in the financial sector. If, on the other hand, the relevant provisions of the BRRD are interpreted laxly and leave ample discretion to local authorities to bail out banks, rational actors will continue to price bank capital inadequately. Moreover, the necessary restructuring and consolidation of the European banking industry will be retarded. The resolution regime will suffer lasting damages and key goals of the regulatory overhaul after the financial crisis will be missed.

Nevertheless, key European institutions seem to ignore this threat and send positive signals to the Italian government which plans to bail out MPS with € 6.6 bn of taxpayers' money. According to the relevant BRRD rules, the losses a failing bank incurred should generally be borne by its investors according to a pre-determined waterfall. Before a minimum bail-in of investors amounting to at least 8% of total liabilities has occurred, government money can only be injected in exceptional cases as a "precautionary" recapitalization "to remedy a serious disturbance in the economy of the Member State and preserve financial stability" (art. 32(4)(d) of BRRD). Indeed, the legitimacy of the bailout provided to MPS hinges pivotally on being recognized as a "precautionary recapitalization" preventing a systemic event.

[1] A German version of this paper appeared in the Frankfurter Allgemeine Zeitung on 3 February 2017.

In order to avoid a dangerous bending of the rules, any determination of a “serious disturbance in the economy” of a Member State and an impending peril for financial stability should be based on hard economic evidence. A detailed analysis regarding the importance of MPS for the stability of (the Italian) financial sector is not possible for outsiders due to a lack of detailed data. However, the size of MPS does not suggest that its resolution might trigger a systemic event. MPS has total assets of about € 170 bn (September 2016), representing only about 4.5% of the Italian banking sector. Moreover, the bank is primarily engaged in standard deposit taking and lending activities and thus most likely not too-interconnected-to-fail. Moreover, it is important to recall that worries regarding the viability of the bank have already prevailed for several months – particularly since the bank failed the EBA Stress Test in July 2016. As a response, the bank and the Italian government took measures to increase MPS’ capital but market participants showed no interest in acquiring troubled assets or providing additional capital. While the banks’ share prices dropped continuously, no further repercussions regarding the stability of the financial system emerged. For this reason, we do not see any of the relevant indicators pointing toward a systemic event if there were an MPS resolution.

Admittedly, MPS is a case with many idiosyncratic elements, most notably the (alleged) mis-selling of bonds to small private investors. It is comprehensible that the Italian government wants to reimburse these retail investors if a bail-in happens. However, it should do so by directly and exclusively supporting these investors and not by funding the troubled bank and, at the same time, putting the whole European bail-in regime at stake. Similar issues will always arise in a bank failure so that the critical lesson for policy makers ensues to effectively restrict the holdings of bail-in capital. It would be a mistake if the rules mandating private sector involvement were weakened during transition because the damage would carry over to the steady state.

It is important to note that digging the grave for the bail-in tool is a joint effort of all key players in the field. Both the European Central Bank (ECB) and the Single Resolution Board (SRB) can reject the determination that the conditions for a “precautionary recapitalization” are met and can trigger instead ordinary resolution proceedings with a full bail-in of investors. Both institutions have access to detailed and confidential data of the Italian banking sector. Should they come to the conclusion that a resolution of MPS would trigger a systemic event, they should substantiate their assessment with data-based projections in order to avoid negative reputational effects for themselves: the impression of forbearance would compromise the two main institutions of the banking union. Moreover, the European Commission has to sign off the capital injections under the EU State aid framework and can thus also prevent the bailout from going forward. As a consequence, the Commission also has its reputation at stake.

We appeal to those responsible to change their minds and turn to a stringent, impartial and consistent application of the bail-in tool. This would not only send a strong signal to markets with all the intended consequences but also mute concerns that European rules are not enforced in case of emergency – be reminded of the Stability and Growth Pact. The next resolution case might not be far away. It would be assuring if we knew the hands of decision makers tied by then.