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# Comment on the European Parliament Draft Report on the proposal for a recovery and resolution directive (Rapporteur: Gunnar Hökmark)

## – Doc 2012/0150 (COD) of 11 October 2012 –

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# Comment on the European Parliament Draft Report on the proposal for a recovery and resolution directive (Rapporteur: Gunnar Hökmark)

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This present comment suggests an amendment to the proposal for a directive of the European Parliament and of the Council, establishing a framework for the recovery and resolution of credit institutions and investment firms. The current proposal focuses on bail-in, but does not sufficiently take into account the pressure exerted on central bankers, supervisors and politicians by the fear of interbank contagion. The only way out of this hold-up type of situation can be found in bail-in bonds. Bail-in bonds are dedicated loss taking debt instruments, whose status of being first in line if it comes to default is clearly communicated from day one.

The suggestions for dedicated *bail-in bonds* is one of the main proposals contained in the Liikanen Report (dated October 2, 2012)[2]. The Liikanen Report makes the resolvability of banks the key challenge for structural regulatory reform. The report argues that without a proper mechanism to wind down troubled banks, including the largest ones, the taxpayer will always be forced to intervene, and to ensure bank system stability.

The high degree of potential contagion between banks is a recent development. It has been caused by the rise of interconnection between financial institutions, which in turn is caused by direct interbank lending, by derivatives exposures between banks, and by an increased level of asset correlation and ensuing liquidity risk.

For any solution of the too-big-to-fail and the too-interconnected-to-fail problem to be effective, the contagion between banks has to be reduced significantly. More precisely, for bank resolution to function properly when a particular bank is in trouble, the supervisory agency entrusted with a restructuring mandate must be able to act without fearing the collapse of the financial system at large.

Consider the bail-out cases witnessed during the past 5 years in several European countries, including the UK, NL, B, GER. In almost all cases the bail-out (i.e. the use of taxpayer money) was justified ex-post by the imminence of default contagion in the banking system. Press reports have stressed the role of contagion risk in discussions among supervisors as the main argument for the unavoidability of bail-outs.

The willingness of central bankers and supervisors to bail out banks by the use of public money must, of course, be seen against the background of the Lehman collapse in 2008, and the lesson it holds for posterity. This lesson was simply this: do not underestimate the intensity of bank interconnection in today's banking markets.

What is the lesson to be learned from this experience for the regulator? The Liikanen Report draws two important conclusions in this regard: First, increase bank

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[2] The report is available for download at: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

resolvability by limiting the influence of short term exposures from banks' trading books (separate banking proposal). Second, make *some* bank debt (*bail-in debt*) contagion-free by enforcing a holding ban on bail-in debt for all banks.

The second point is an important advancement of the bail-in proposal included in the current draft of the RRD. In the current version of the RRD, bail-in is rightly positioned in the core of the proposal. Through an effective bail-in mechanism, the tax-payer can be spared of bank rescues, except for the most extreme systemic crises.

However, the current proposal, though it focuses on bail-in, does not consider sufficiently the pressure exerted on central bankers, supervisors and politicians by the fear of interbank contagion. The only way out of this hold-up type of situation can be found in bail-in bonds. Bail-in bonds are dedicated loss taking debt instruments, whose status of being first in line if it comes to default is clearly communicated from day one.

Investors in bail-in bonds thus know the risky nature of their investment, and the market is able to price these instruments accordingly. The coupon of bail-in bonds will be significantly higher than that of other debt instruments. An important covenant of bail-in bonds is the holding ban. Other banks are not allowed to invest into bail-in bonds. This effectively reduces the risk of default risk contagion. Put differently, the holding ban renders the pre-announced bail-in credible, since supervisors need not fear contagion risk for bail-in debt.

An important question relates to the size of the bail-in debt layer, and the existence of investor demand. While the Liikanen proposal has left the calibration of the size of the bail-in debt layer to the Commission, a likely size of the bail-in debt layer is about 5% of total assets. Based on average equity capital in the banking system, a 5% debt layer would roughly double the size of contagion-free loss absorption capacity in the banking system.

We have no hard evidence on investor demand for such a new class of bail-in bank debt. The experience of Credit Suisse, however, suggests that there is strong demand for this type of debt (CS' primary issue of bail-in debt in the form of coco bonds was ten times oversubscribed). Nevertheless, to allow a market for bail-in bonds to develop properly, a 5+ year build-up period is highly recommended (phasing-in). There are further ways to ease the acceptance of bail-in bonds by the market. E.g., clearly defined trigger rules (as in the case of the new Swiss bail-in regulation), or allowing bail-in bonds to differ by seniority.