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Sustainable Architecture for Finance in Europe (<https://safe-frankfurt.de/>)

SAFE Finance Blog

The Bail-in Tool is too Complex

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Tobias Tröger: The BRRD will not reach its policy objective



Two interrelated objectives of the regulatory strategy after the recent financial crisis were to preserve public finances ex post by avoiding a bail-out with taxpayer's money and to instill market discipline ex ante. A cornerstone of the reform agenda has been the introduction of the bail-in tool, which compels investors in bank capital to absorb the losses of a failing institution. In a new SAFE Working Paper (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023184), Tobias Tröger (<https://safe-frankfurt.de/research/researchers/researchers-details/showauthor/56-troeger.html>), SAFE Professor at

Goethe University Frankfurt, judges the current European resolution regime to be largely “ineffective. The regulatory framework is highly complicated and gives authorities ample discretion in compelling private sector involvement (PSI),” Tröger argues.

Desirable market discipline could only be induced if investors were able to predict the risk of their capital instruments being written-off or converted with reasonable certainty. Unfortunately, the ad hoc bail-in tool under the Bank Recovery and Resolution Directive (BRRD) complicates the prediction of outcomes for investors and thus impedes risk-reflecting prices for bank capital, Tröger criticizes. “The manifold decision alternatives that exist under the BRRD make predicting the respective outcome of resolution an endeavor akin to a 30-day weather forecast.”

He identifies several key requirements for an efficient bail-in regime that allows sophisticated investors to price the risk they incur adequately, which are suboptimally implemented in the BRRD. Firstly, the bail-inable instruments have to be held outside the banking sector by investors with sufficient loss-bearing capacity, such as insurance companies, pension funds, high net worth individuals or hedge funds. Secondly, a well-designed bail-in tool needs to include a clear-cut and difficult to circumvent definition of the trigger event. And finally, it has to make bail-inable capital instruments identifiable and to allow a prediction of the particular consequences when the tool is implemented (e.g. haircuts and conversions occur automatically without discretion).

Supervisory and resolution authorities’ broad discretion could lead to widely diverging outcomes with regard to the determination of the trigger for resolution, the application of the bail-in tool and the specification of liabilities subject to bail-in as well as the limits of PSI. In addition, the current framework is incomplete as it does not provide satisfying holding restrictions for investors of bail-inable bank assets, Tröger states.


“Yet, it is well plausible that neither a conducive amendment of the resolution regime nor its constructive implementation is politically desired,” Tröger concludes. European (universal) banks lack profitability and are further squeezed by international competition. “Raising the costs of doing business by aggravating financing conditions will, at a margin, lead to a downsizing of the sector in overbanked Europe, which inter alia entails job losses that raise political concerns.”

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