WORKING DOCUMENT # 52
Crisis Management & Bank Resolution Directive
Working Party on Financial Services
12 March 2013
FROM: Italian delegation

Italy non-paper on bail-in

1. Executive Summary

Italy supports a targeted approach to bail-in, ie. a bail-in applicable to a new set of securities with clear contractual provisions acknowledging the statutory power of the resolution authority to write-down or convert into shares the relevant debt when the institution meets the trigger conditions.

The main reason convincing Italy to prefer a targeted approach to bail-in is the need to equip the authorities with a *credible* resolution tool, ie a tool that can be used to resolve a SIFI quickly and effectively, without negative effects on the financial system.

We believe that a targeted approach would reduce the risk of undesired consequences on the financial stability linked to the introduction of bail-in as a resolution tool both from an *ex ante* and an *ex post* perspective:

- *ex ante*: by limiting the write-down and the conversion power to *a specific class of investors* it would limit the risk of run at the first signs of difficulties and would reduce arbitrage opportunities linked to the definition of classes of debt that are excluded from bail-in;

- *ex post*: by limiting the write-down and the conversion to the claims of investors *who have made an informed investment decision*, it would facilitate the choice to apply bail-in by the authorities and may reduce the risk of contagion if investors are required to be non-bank institutions.

We are especially concerned that the difficulties that the authorities would face when using the flexibility that, to some extent, seems unavoidable when designing the tool could lead them preferring *not to use the bail-in at all* thus undermining its credibility as a resolution tool (time-inconsistency).[1] This also considering that after a bail-in is applied to the first sizeable systemic important institution, the funding conditions on the interbank markets could worsen if not dry up completely, the more dramatically the wider the scope of a statutory bail-in is.

In addition, a divergent assessment of the costs and benefits of bail-in as a resolution tool in terms of financial stability could lead the EU resolution authorities to adopt different policy responses and resolution strategies that could undermine the equal treatment of creditors in the EU and create spill-over effects in the single market.

[1] "Like all policy rules, resolution rules face what economists call a time-consistency problem. Whether a rule is followed in practice depends on the balance of costs and benefits at the time crisis strikes, not at the time the rule is written. That is why policy might in practice lack consistency over time (i.e time-inconsistency) A. Haldane, "On being the right size", Institute of Economic Affairs' 22nd Annual Series, 25 October 2012.

An additional issue worth considering relates to the bail-in not being only a resolution tool but also one *source of funding* on which the authorities should be able to rely when financial stability is at risk through the additional loss-absorbency capacity offered by bail-inable debt. The availability of adequate private funding for resolution is crucial in the EU to break the vicious link between sovereigns and banks. Only the adoption of a targeted approach *would clarify the interaction* between the resolution costs to be borne by the firm-specific creditors and the costs to be sustained by the banking system as a whole through the resolution fund. In particular, the fund would *always be required* to sustain the costs of resolution exceeding the amount of loss-absorbency capacity available; the authorities would then be in a position *to act quickly* every time they face the crisis of a systemic institution.[2]

The approach proposed by the Commission - that allows meeting the minimum requirement of eligible liabilities with special subordinated debts - should be partially modified so as to ensure that the minimum requirement is *only* met with equity, non core capital, subordinated debt and senior long term debt. Any losses and other costs of resolution exceeding the loss-absorbency capacity of institutions should be sustained by the resolution fund.

2. The policy rationale

2.1 The ex ante effects

One of the main issue to be addressed when designing bail-in as a resolution tool is the scope, ie the liabilities to which it can be applied. Two approaches are possible:

- all the liabilities of an institution with the exception of some that are explicitly excluded (ie comprehensive approach or, in the Presidency paper, statutory approach).
- only a new set of liabilities with clear contractual provisions acknowledging the statutory power of the resolution authority to write-down or convert into shares the relevant debt when the institution meets the trigger conditions (targeted approach or contractual bail-in).

In principle, a comprehensive statutory approach with very limited exclusions would be the most effective one: a wide range of liabilities would be available to absorb any amount of losses threatening the solvency of institutions and to recapitalize them or the bridge banks continuing to provide the critical financial services.

However, even in a comprehensive approach some debt should be excluded from the scope. We should certainly exclude secured liabilities, to be consistent with the insolvency ranking, but also liabilities that are not easily and quickly bail-inable (eg derivatives) and liabilities whose inclusion might cause undesired consequences on financial stability, eg very short-term debt, derivatives cleared through CCPs.

Indeed, short-term funding evaporates at first signs of difficulties and this negative effect could exacerbate if resolution becomes a more credible option as a result of the new regime. Excluding short-term debt would be appropriate for stabilizing the funding and giving time to the authorities for choosing the most suitable resolution action when a bank is approaching the point of non viability.

[2] The actual burden on firm-specific creditors and on the resolution fund would depend on the calibration of the minimum requirements for bail-inable debt.

But excluding short-term debt, especially regardless of the tool which is used[3], has many drawbacks:

a) it would not be consistent with the insolvency ranking that among senior unsecured creditors does not make any difference based on the maturity of claims. Any departure from the ranking in insolvency would require the assessment of the *no creditor worse off principle* and a creditors' right to a compensation;

b) it would distort incentives by leading banks to rely on short-term funding that, by becoming less risky (short term funding would become a riskless asset if the hierarchy set up in article 43 is extended to all the resolution tool) would certainly be available at a lower price. Minimum requirement to offset this risk would not reduce the incentive for banks to do all they can to exploit a cheaper source of funding. And we should not underestimate the risk that banks try to circumvent any new requirement which is set by the authorities.

c) it would not reduce the risk of contagion linked to the nature of the counterparties, where interbank debt has a maturity longer than the one which is excluded.

A solution for addressing the issues under b) and c), but not for a), would be to leave flexibility to the authorities that could decide on a case-by-case basis if short-term debt and interbank debt should be excluded.

However, *flexibility* too has great disadvantages both from a *policy* and a *legal* point of view.

a) from a policy perspective flexibility would leave room to different policies by EU resolution authorities in deciding to which liabilities apply a bail-in; this could lead to unequal treatment of creditors in the single market and could create spillover effects arising from different resolution strategies adopted by jurisdictions, that could decide to use flexibility for not applying bail-in at all, depending on their assessment of the costs and benefits of bail-in as a resolution tool;

b) from a legal pont of view we underline that, to not incur in a violation of the ECHR, it is the law that should establish which classes of creditors may be subject to bail-in or at least it should define objective non-discriminatory criteria permitting to identify homogenous groups of creditors guiding the action of the authorities when applying a bail-in.

c) flexibility also would increase the risk of litigations for the authorities that should justify their assessment of the different degree of systemic risk of different groups of creditors and in different specific circumstances.

To sum up, we face a policy trade-off where *more flexibility* would be needed to avoid introducing arbitrage opportunities and wrong incentives, to reduce moral hazard and to address the risk of contagion while *less flexibility* would be required to avoid the risk of run, to increase legal certainty and predictability, to ensure equal treatment of creditors in the EU and to reduce the risk of litigations for the authorities.

[3] Avoiding completely runs would require protecting short-term debt not only in the bail-in regime but also across all the resolution tools, e.g. by always transferring short-term liabilities to a bridge bank. This would mean extending the hierarchy of creditors for bail-in set in Article 43 to all resolution tools.

A *targeted approach* to bail-in represents an option that would avoid choosing between more or less flexibility and their significative policy drawbacks.

2.2 The ex post effect

We believe that the difficulties that the authorities would face in using the flexibility that may be unavoidable when designing the tool could lead them preferring *not to use the bail-in at all* thus undermining its credibility (time-inconsistency). This also considering that the day after a bail-in is applied to the first sizeable systemic important institution the funding conditions on the interbank markets could worsen if not dry up completely, the more the wider the scope of a statutory bail-in is.[4]

To conclude we believe that a targeted approach is the only way to overcome difficulties and make bail-in a simple and credible tool for resolving crisis quickly and effectively.

2.3 The interaction with funding provisions

A targeted approach would ensure smooth application of the FSB principle stating that creditors' resources should be *exhausted* before making recourse to the resolution fund.

The KA principle, which is implemented in Article 92.2 of the directive, is consistent with the aim of protecting taxpayers, reducing moral hazard, make creditors accountable for reduced monitoring and market discipline. However, a strict application of the principle would mean that creditors should always bear losses until the limit set by the *no creditors worse off* principle is reached, as only in this case creditors' resources can be considered being *exhausted*. But where this is the case, one of the key arguments justifying the sacrifice of creditors' rights from a legal point of view (ie being more advantageous for creditors than liquidation) would fall.

In addition, as shown by the ongoing debate at the Council, some delegations require more flexibility in the application of the principle, given the potential systemic consequences of its strict application. However, if flexibility is accepted, bail-in might not be used at all in practice, or only in a very few cases, depending on the assessment by the competent authorities of its costs and benefits in any specific case.

A targeted bail-in would make it *easier to draw the line* between the burden that should be borne by creditors and the one to be sustained by the banking system, through the resolution fund, ie the fund would *always be required* to sustain the costs of resolution exceeding the loss-absorbency capacity which is available. The authorities would then be in a position *to act quickly* every time they face the crisis of a sizeable systemic institution.

The burden on firm-specific creditors and the one on the resolution fund would depend on the calibration of the minimum requirement of bail-inable debt.

[4] C. Goodhart "Basel marches down wrong path to tackle systemic risk", Financial Times 7 July 2011.

3. The Italian proposal

The approach proposed by the Commission - that allows meeting the minimum requirement of eligible liabilities with special subordinated debts - should be partially modified so as to ensure that minimum requirements are *only* met with equity, non core capital, special subordinated debt and senior unsecured long-term debt. Any losses and other costs of resolution exceeding the institution’s loss-absorbency capacity should be sustained by the resolution fund.

The requirement should be set in terms of RWA instead of total liabilities: since the tool is aimed to achieve an adequate recapitalisation, the amount of bail-inable debt should properly take into account the riskiness of the assets of the institution. Consistency with the prudential requirements would also be ensured. The impact assessment of the Commission would provide the basis for the calibration so as to ensure that adequate bail-inable debt is available.[5]

The entry into force of the regime could provide for a transitional period (i.e. 2016-2018) during which banks should be required to gradually build the minimum requirement; during this period bail-in should not be applicable. The entry into force of the regime could be set at 2019, in line with the entry into force of the Basel 3 reform.

We would exclude a grandfathering so as to avoid cliff effects around the chosen date (a significant amount of liabilities would be issued before that date, substantially benefiting of an implicit state guarantee, while after that date banks’ access to market funding could become very difficult). In addition, a sufficiently long transitional period, with the entry into force set at 2019, would make a grandfathering not necessary.

[5] According to explanatory memorandum to the Directive, on the basis of evidence from the recent financial crisis and of performed model simulations, an appropriate percentage of total liabilities which could be subject to bail in could be equal to 10% of total liabilities (excluding regulatory capital)