

Feature

KEY POINTS

- Bail-in securities are market-based insurance instruments but using market prices to protect us from market failure was and is always going to fail.
- Bail-ins across a number of banks at the same time, coupled with the downgrade of cocos issued by other banks and the resulting adverse shifts in risk appetite and uncertainty will create a crisis centred in the financial markets.
- The best way of protecting taxpayers in the long run is to rely on three familiar, tried and tested elements.

Author Professor Avinash D Persaud

A ticking time bomb: TLAC and other attempts to privatise bank bail-outs

Regulators and bankers have struck a deal where big banks have to carry a significant amount of additional “total loss absorbing capital” (TLAC) but the additional amount can be in forms of capital that are cheaper to raise than equity. The market has responded enthusiastically, with banks issuing new bail-in securities at rock bottom yields. The intention is that these new instruments will save taxpayers from having to rescue banks, but, they will not work and will likely draw new players messily into the centre of the next crisis.

Financial crises are hard to predict, but perhaps the earliest indicator is the hubris of regulators. Grandly billed as the step to banish “too big to fail” forever, the Financial Stability Board announced on 9 November 2015 the minimum “total loss-absorbing capacity” (TLAC) requirement for the 30 banks identified as globally, systemically important (G-sibs). From 1 January 2019, the minimum TLAC requirement for these banks will be 16% of the group’s risk-weighted assets increasing to 18% from 1 January 2022. Emerging market G-Sibs can meet these minimum

above its capital ratio. The idea is that they will enable a bank to stay afloat without threatening market instability and requiring taxpayer support. Before the ink had dried on the TLAC agreement, banks were falling over themselves to issue these new ‘bail-in’ securities, which investors greeted enthusiastically. At one point ten-year yields on these instruments were close to 2.5%. Pity then that these bail-in securities are likely to make the financial system less safe.

Reliance on bail-in securities is well intentioned if mis-guided. The Global Financial Crisis witnessed a conversion

in securities will make tax payer bail outs smaller, less frequent and will curb any incentive to take risks now in the hope of a bail out later. This article explains why these bail-in instruments will not work. Worse, why they will bring forward a financial crisis and spread it to places that will be harder to tackle. Taxpayers will end up worse off. Bail in securities are fools’ gold.¹ This is an apt description. Fools’ gold’s metallic lustre gives a superficial resemblance to gold. However, it is common iron sulphide that can be used to spark a fire. By explaining why bail-in securities and similar attempts to privatise bail-ins cannot work to protect the financial system and tax payers, it will become clearer why we must follow the messy alternative of central bank liquidity, temporary nationalisations, the cramming down of bond investors and the creation of bad banks. This is the most reliable way to protect taxpayers from a crisis that has started.

THE POLICY CYCLE

There is a cycle to regulatory reform. In the immediate aftermath of a major financial crisis, such as the recent Global Financial Crisis, the time is ripe for radical reform. Deluded cries of “this time is different” heard during the previous boom, are replaced with angry shouts of “never again” as the bust unfolds. Crises are the handmaiden of much financial reform. For example, the requirement that banks must publish audited accounts can be traced back to the collapse of Royal British Bank in 1856. The US Federal Reserve was created in 1913 as a direct response to the “Financial Panic” of 1907. The 1929 stock market crash gave birth to the Glass-Steagall Act 1933 that separated US commercial and investment banking for over fifty years. The 1974 establishment of the Basel Committee of G10 Bank Supervisors

Before the ink had dried on the TLAC agreement, banks were falling over themselves to issue these new ‘bail-in’ securities, which investors greeted enthusiastically.

thresholds on 1 January 2025 and 1 January 2028 respectively. This sounds tough. Revised Basel II or Basel III rules already require international banks to meet a minimum capital ratio of 10.5% of risk-weighted assets (RWAs), making this an additional 5-7% of risk-weighted assets that must be held in instruments that qualify as TLAC but need not qualify for Basel’s capital ratio, which is essentially made up of shareholders’ equity. These TLAC-eligible instruments are those that do not begin life as equity but can be automatically written down or converted into equity to enable a going concern to stay

of private recklessness into public sector debts, as governments “bailed-out” large swaths of the banking and financial system following a period of excessive private sector borrowing and lending. Concern over the sustainability of these public debts, arguably over-done, led in varying degrees to “austerity” policies. The spectre of the state crimping welfare programmes to finance bankers’ past indiscretions has powerfully affected the public, politicians and financial sector regulators. Protecting taxpayers from a repetition of this is now a policy imperative. The idea is that bail-

followed the dramatic collapse of Bankhaus Herstatt in June of that year.

The moment for radical reform is in the direct aftermath of a crisis. If this opportunity is not grasped it soon submerges and bad reforms often surge in. Regulators, busy extinguishing the fires of a financial crash, often quickly recognise the technical point of origin. Despite having their fingerprints all over the previous, flawed, bank regulations that contributed to the last crisis,² the Basel Committee delivered a blueprint for meaningful reform as early as April 2009 – merely seven months after the Lehman Brothers' collapse. Basel III is an attempt to address some of Basel II's failures and push regulation in the right direction, especially in the key area of funding liquidity.

If that moment is lost however, the policy cycle turns. When tax payers' money is seen to be bailing out wealthy, under-taxed bankers, and the ensuing government deficits lead to the scrapping of social programs, justifiable moral indignation morphes into understandable anger. This anger, fanned by salacious revelations of individual villainy undermine the earlier consensus of what went wrong and creates a backlash against government bailouts. Taxpayers are no longer willing to be cast as the lender or insurer of last resort. The roar in the streets is for greater retribution and alternatives less reliant on the State and taxpayers. These circumstances have ensured the popularity of "bail-in" instruments or similar mechanisms without critical examination.

WHY BAIL INS WILL NOT WORK AND COULD MAKE A CRISIS WORSE

Bail-in securities are also known as hybrid bonds, "cocos" or "wipeout bonds". In essence a bail-in security is a bond that pays a coupon in good times. When bad times strike, indicated by the ratio of capital to risk-weighted assets falling below some pre-assigned level, the instrument converts into equity that is subordinated to all debt and at risk of total loss. This new equity injection automatically dilutes existing shareholders. Regulators have approved instruments with an additional, earlier trigger level that leads to the coupon being unpaid but not converted.

The instruments could be contingent, convertible, capital instruments (so-called "cocos"). Alternatively, the bail-in may be part of an official resolution regime where bond creditors must be bailed in before there is any public capital injection as in the case of the EU's, 2012–2013 rescue packages for Cyprus. A hybrid can also be used where the authorities treat certain instruments with pre-approved, automatic bail-in features as permissible forms of regulatory capital. Automatic bail-in securities promise to rectify failing banks early with minimal financial fall out and taxpayer exposure. This all seems quite proper. The popular image of bankers making large bets with other peoples' money, running off with the winnings or leaving the losses for tax payers to pick up, has given this initiative political salience.

Using market prices to protect us from market failure was and is always going to fail. Financial crashes happen when markets least anticipate them.

BAIL-INS AND THE MAL-DYNAMICS OF A CRISIS

If banking crises typically began with a single idiosyncratic bank failure, attributable perhaps to the antics of a rogue trader, but the failure causes panic to spread and other banks get pulled into the maelstrom, then bail-ins may work. But that is only common in textbooks or in the period before deposit insurance. Moreover, today, idiosyncratic failures are the ones that the authorities are good at managing. The FDIC quietly tidies away these kinds of collapses routinely. In the UK, the unspectacular closure of Barings Brothers in 1995 is the oft-used example. But modern banking crises do not typically occur that way. Instead, during the period preceding the crisis almost all banks appear to be performing safely and to the satisfaction of their supervisors with capital well above regulatory minimums. There is a paucity of work for the administrators at the FDIC or other regulators to do. Just two years before the last crisis developed regulatory conclaves and central bank Financial Stability Reports in 2005 dismissed the notion that banks could be a

source of weakness pointing to historically high capital levels and the new, clever, market-based risk management techniques. Then the boom ends and in rapid time almost all the banks look to be in deep trouble at the same time.

Most financial innovation is a modern manifestation of an old idea. There hasn't been much fundamental financial innovation since grain futures were traded in Mesopotamia a few thousand years ago. Bail-in securities are nothing new. They are market-based insurance instruments. While the terminology might be modern, they are a throwback to the philosophy at the heart of the Basel II Accord that made the market pricing of risks the front line defence against financial crises and spawned risk management technologies such as Value At

Risk and Credit VaR. Financial crises are a result of a market failure. Using market prices to protect us from market failure was and is always going to fail. Financial crashes happen when markets least anticipate them. If markets heavily anticipated a crisis – like the decade long anticipated collapse in the US dollar under the weight of large trade deficits – either it will not arrive or it will be far more modest. Bail-in investors and credit rating agencies will underestimate risks in a boom and be shocked in a downturn.

Even before the economy is fully free of the clutches of the Global Financial Crisis, investors have been queuing up to buy coco bonds at levels of interest rates considered low historically, but which look good compared with near zero interest rates on short-term deposits or Treasury bills. In February and early March last year, several months before the FSB published details on what would constitute TLAC, a host of European banks issued 10-year subordinated bond deals, as they sought to grow a new market for these TLAC-eligible instruments. Crédit Agricole took €16.5bn of orders from investors for its €3bn bond –

Feature

the largest bail-in bond ever sold. Deutsche Bank attracted a €4.4bn order book for its €1.25bn deal priced at just 210 basis points over government paper. Société Générale took €3.8bn of orders for a €1.25bn transaction at 190bp over. BNP Paribas drew €5.5bn of demand for its €1.5bn offering at 170bp over. At one point last year and despite the difficulty in pricing the risk, investor yield-hunger drove coupons down to just 2.6%. Does anyone believe that these miserly rates and spread over risk-free assets is a fair measure of the risk that a bank may need a capital injection at any point over the next ten years?

In stable times, bail-in investors will use the optimistic valuations of these instruments as collateral against other investments and expenditure. When an event occurs that brings prices crashing down, bail-in investors will lose substantially

order to confirm their fears is not available they assume the worst. Bail-ins are supposed to happen before a bank has failed, to avert failure, but bail-ins across a number of banks at the same time, coupled with the downgrade of cocos issued by other banks and the resulting adverse shifts in risk appetite and uncertainty will create a crisis centred in the financial markets. It is far harder to resolve a crisis centred in the financial markets with many disparate players than one centred in a handful of banks. Protagonists of cocos sometimes argue that, for instance, Europe only required another €150bn of capital to offset bank losses and bail-ins of this large but not overwhelming sum would not be destabilising. This is how it may look long after the embers of a financial crisis have cooled. But in the middle of a crisis when bail-ins would be triggered, the markets will be paralysed by uncertainty and spooked by speculation of

It is far harder to resolve a crisis centred in the financial markets with many disparate players than one centred in a handful of banks.

and simultaneously. As bail-in investors face gaping, unanticipated losses, aggregate uncertainty will rise sharply and market participants will swing into risk aversion mode. The ensuing fire sale of assets will send asset values into further decline, further undermining the solvency of the banking system.

There are a number of different mechanisms that generate this collective risk aversion. Markets will search for institutions that look like the ones in trouble or have any shared exposures or assets with those, which are. One avenue of contagion will be the likely downgrades of other cocos the minute one is unexpectedly converted into equity in the emerging down phase of a financial cycle. A similar effect was seen during the Global Financial Crisis with the downgrade of CDOs and other packages of credit derivatives and during the Asian Financial Crisis with the downgrading of sovereign government bonds.

In this febrile environment where the information market participants demand in

losses many times greater than the realised losses once the system has been stabilised.

WHO SHOULD BUY BAIL-IN SECURITIES?

Who should buy these securities is a critical, vexing, question. In the interests of financial stability, it should not be other banks or investors who get their leverage from banks like hedge funds. They would then have to make pay outs when they were least able to do so, increasing the likelihood of a liquidity-sapping fire sale of assets. Regulators are convinced that long-term investors should own bail-in securities. This is in danger of saving taxpayers by pushing pensioners under the bus. Moreover, bygones are bygones, and no matter how it was meant to be prevented, once a crisis has arrived, it will be argued that the economic consequences of imparting a large current loss to pensioners – who tend to spend much of their pension income and are a politically powerful group – is likely to be more severe than giving a liability to future tax payers.

Investment theory suggests these securities are exactly the wrong kind of assets for long-term investors. Long-term investors such as life insurers or pension funds should hold assets where risks fall over time – like public and private equity where being long-term is an advantage. They should shy away from assets where risks rise over time, like a bail-in bond. The probability of a bail-in bond being bailed in over the course of one day is much smaller than over the course of one year or over one decade.

Bail-in proposals make for good politics but poor economics. Ostensibly, their *raison d'être* is to save taxpayers. Yet the experience of resolution-inspired “creditor bail-ins” such as Lehman’s in September 2008 and Cyprus in the spring of 2013, is that they are far more costly than when taxpayers are temporarily but directly engaged. This is borne out by the experience of Lloyds and RBS in the UK or AIG where the US government realised a profit of USD\$22.7bn. The harsh truth is that once regulation has failed and a financial crisis is upon us, the only player with copious amounts of the assets that matter, good credit and much time, is the taxpayer.

THE GENERAL CASE

Its not just cocos that will not work. Any attempt to privatise bailouts will likely make matters worse than they need be. At a conceptual level, liquidity is a public good and it has been long shown that the private sector will under-provide public goods. This is especially so given that the public sector can create liquidity in a crisis much more cheaply than the private sector. Private provision of systemic liquidity will always be economically inefficient compared to public provision. The amount of liquidity and capital required to insure a bank against a time when all liquidity freezes and all asset valuations collapse is not viable at a systemic or institutional level. Banks would become no more than safe deposit boxes, unable to provide significant credit and struggling to compete with the space underneath the mattress. Perhaps systemic crises would be better understood if they were defined

Biog box

Professor Avinash D Persaud is a non-resident Senior Fellow at the Peterson Institute for International Economics in Washington and Chairman of Intelligence Capital in London. Avinash was chairman of the Warwick Commission and the regulatory sub-committee of the UN Commission on Financial Reform; Member of the UK Treasury's Audit and Risk Committee and the Pew Task Force to the US Senate Banking Committee. Email: apersaud@piie.com

as that scale of crisis that cannot be privately self-insured.

Another perspective is that the problem we are trying to solve is a problem of homogeneity, a problem that is common to other "systemic failures" like urban traffic jams or the tensile collapse of construction materials. Liquidity crises are about homogenous behaviour – the demand for liquidity rises sharply as everyone runs for the exit at the same time. The terrific tensile strength per weight of bamboo and the webs of spiders is based on the complex nature of their internal make up. Similarly, to create financial system resilience we need heterogeneity of behaviour.

In the liquidity crisis we need actors who have liquidity and are willing to provide it at that point. This fits the description of central banks well, but privately organised pension funds and life insurance companies also fit that bill. Courtesy of their long-term liabilities, they are potentially and desirably heterogeneous agents with respect to a bank liquidity crisis. There is an important systemically strengthening role they can play if they were allowed to. Current insurance and pension fund regulation applies bank-like valuation and risk-management principles, turning them from heterogeneous agents willing to buy when short-term players are trying to sell, into homogenous ones, trying to squeeze through the exit at the same time.

CONCLUSIONS

Proponents of bail-in securities argue that knowing the public sector will bail out banks makes them take greater risks. This argument sounds right but begins to unravel on inspection. Most so-called bailouts have left shareholders with little and forced bondholders to suffer a haircut. Central banks try to adhere to the adage that it is the banks that are bailed out, not the bankers. Maybe this could be more explicit and broader. While few CEOs survive, most directors and managers do. Moreover, the alternative to bail-ins is not unconditional bailouts of all and sundry. The best way of protecting taxpayers in the long run is to rely on three familiar, tried and tested elements.

It is to the public sector that we must turn to when liquidity dries up, to provide copious quantities of it against reasonable collateral à la Thornton and Bagehot. This will be sufficient for those institutions, who, ex post, have been most prudent and are not overlaid with non-performing assets or those that are hard to price. They are few.

The balance of institutions can be broken down into two camps. There are those for whom the environment of risk aversion and their inability to price part of their assets casts a disproportionate shadow over the rest of the institution. The tendency, observed during the current European debt crisis, the Japanese Deflation in the 1990s and the US

Nationalisation is the policy that dare not speak its name, but the cheapest, quickest route for tax payers to deal with these institutions is to temporarily take them over...

Savings and Loans debacle in the late 1980s, will be for these institutions to sell-off their liquid assets to meet current liabilities and to hang on, often with regulatory forbearance, to the hard-to-price assets in the hope that the risk-aversion will lift or economic conditions will improve. While this allows them to survive, their balance sheets are locked up. These "Zombie banks" are unable to respond to any demand for loans and greet every upturn with the sale of assets. They end up acting as weight on the recovery. The tried and tested solution to this group is a "Bad bank" that purchases these assets at, say a 33% discount to their historic cost, with the potential of returning any residual profits to the banks after the public-sector has recouped all of its outlays. Compared to unrealistic pre-crash valuations, shareholders will suffer a loss, but they would likely be relieved by the injection of liquidity and the reduction of uncertainty. The object of the bad bank is to enable the remaining "good" banks to raise private capital and liquidity. It is also to repackage bad assets in a way that would be attractive to those institutions with long-term liabilities that have liquidity to inject. If such institutions are presented with a stabilising environment and assets that

are cheap over the long run, they are more likely to buy them and this is the best way of drawing in private-sector liquidity.

To encourage the banks to sell their bad debts to the Bad Bank and not seek to minimise shareholder losses by hanging on, banks should first be required to mark-to-market those assets for which they do not have long-term funding and raise additional capital. There will be those institutions, which even after selling assets to the Bad Bank, do not have the credibility to survive without public sector support. In these circumstances, the experience of Japan and other banking crises is that serial injections of public capital will prove a costly failure.

Nationalisation is the policy that dare not speak its name, but the cheapest, quickest route for tax payers to deal with these institutions is to temporarily take them over – which often involves an injection of very little capital. The FDIC-style operation would be to remove managers, wipe out shareholders, subordinate creditors and re-organise and re-structure so as to ready these institutions for re-sale to the market place. ■

- 1 See, 'Bail-Ins Are No Better Than Fool's Gold', Avinash Persaud, Comment Pages, Financial Times, 21 October 2013.
- 2 'Banks Put Themselves at Risk in Basle', A Persaud, Comment Pages. Financial Times, 16 October 2002.

Further Reading:

- Funding arrangements and burden sharing in banking resolution [2012] 9 JIBFL 535.
- Fewer options for capital-raising by banks: more stability? [2015] 11 JIBFL 671.
- LexisNexis Loan Ranger blog: Putting the Bank Resolution and Recovery Directive to the test.