Response to the request for comments on the FSB consultative document on the evaluation of the effects of too-big-to-fail (TBTF) reforms

by

Professor Dr. Axel Wieandt, WHU Otto-Beisheim School of Management, former Head of Corporate Development / Corporate Investments of Deutsche Bank and former CEO of Hypo Real Estate Holding AG

and

Sascha Hahn, PhD student, WHU Otto-Beisheim School of Management

The market´s perception of the credibility of reforms

8. Does the report draw appropriate inferences about the extent to which market participants perceive resolution reforms to be credible?

"Never again" was the impassioned conviction of governments worldwide after being forced to bail out banking institutions and provide guarantees and capital to avert systemic collapse as a result of the global financial crisis of 2007/08. Since then, the responsible international regulatory bodies have developed a slew of new regulations, including enhanced supervision, capital surcharges, and resolution regimes specifically for banks that would jeopardize the financial system if they were to fail.

In Europe, policymakers have agreed on a comprehensive bank recovery and resolution regime, which includes the Bank Recovery & Resolution Directive and the Single Resolution Mechanism Regulation, designed to make banks resolvable if they go bankrupt, but also to rule out bailout expectations and implicit government guarantees. The regime is designed to make banks' debt bail-in-able and to make government bailouts of banks a rare exception.

But is this bail-in regime credible?

By tracking market reactions to the implementation of the bank resolution regime and quantifying the impact of key regulatory events between mid-2009 and mid-2017 on credit default swap (CDS) spreads and stock returns of 260 European banks, we - together with Paul P. Momtaz - conclude that the European bail-in regime alone has not eliminated implicit government guarantees.

Our detailed analyses and results can be found in the following paper:
https://eur01.safelinks.protection.outlook.com/?url=http%3A%2F%2Fssrn.com%2Fabstract%3D3645298&data=02%7C01%7Csascha.hahn%40whu.edu%7C698231500917441feac308d83eebd88e%7Cfd0fb88881d0438694628a094cc4592e%7C1%7C0%7C637328529954854763&sdata=MPtgFqhpjMuBWI15JpiMJCle0anSxhrmzgpDyslkEE4%3D&reserved=0

Worse still, CDS spreads, especially among global systemically important banks, have tightened and equity returns have increased significantly, despite the implementation of the resolution regime.

In other words, the European bail-in regime has not solved the systemic problem of bailout expectations in the market yet. One gaping legal loophole is the “precautionary recapitalization” tool. Recent Italian bank failures are proof that big banks still have the muscle to negotiate with national governments and regulatory agencies to avoid complete bail-in – that is, of course, if avoiding complete bail-in, of individual, political and/or national interest. As long as exceptions to the European bail-in regime are made, banks and investors know that government guarantees are just as implicit as in 2007/08.

It is high time that Europe break the nexus between banks and national sovereigns. If the loopholes of the European bail-in regime are not closed soon, the Banking Union is doomed to fail. As sovereigns issue record levels of government debt to fund the response to the COVID-19 pandemic and the ECB is providing new long-term refinancing operations at attractive negative rates that allow banks in the Eurozone to earn big money on their sovereign risk exposure, the European banking system risks slipping back into the “doom-loop” and threatening the future of the common currency.

We think that the FSB should establish a comprehensive monitoring framework to measure implicit government guarantees (IGG) across major banking markets. In addition, the FSB should analyze the loop-holes in the European bail-in regime and make specific policy recommendations on how to close them. This specifically refers to “precautionary recapitalizations” that have been used by certain EU member states to avoid bank resolutions.

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