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IN-DEPTH ANALYSIS

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

External authors: Elena Carletti
Bocconi University and European University Institute
Donato Masciandaro
Bocconi University and SUERF

Provided at the request of the
Economic and Monetary Affairs Committee

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Abstract

Bail-in can potentially lead to enhanced market discipline and lower use of public finances only if its application is credible and stringent. This requires that the holders of bail-in able debt have the capacity of absorbing losses but also that the application of bail-in does is consistent with financial stability. Sophisticated investors have typically a larger financial capacity than unsophisticated investors but they are also more reactive to information and/or imposition of losses and are therefore more likely to generate runs and systemic risk. In contrast, retail investors are slower movers and as such they constitute a more stable source of funding. As a result, we do not advocate the ban of the sale of subordinated debt to retail investors. Rather, it is crucial that the rules concerning the marketing of these products are appropriately designed and their implementation is supervised by competent authorities.

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AUTHORS

Elena Carletti, Bocconi University and European University Institute
Donato Masciandaro, Bocconi University and SUERF

RESPONSIBLE ADMINISTRATOR

Marcel Magnus
Economic Governance Support Unit
Directorate for Economic and Scientific Policies
Directorate-General for the Internal Policies of the Union
European Parliament
B-1047 Brussels

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ABOUT THE EDITOR

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E-mail: egov@ep.europa.eu

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CONTENTS

List of abbreviations 4

Executive summary 5

1. Introduction 6

2. The origin of bail-in: Burden sharing rules within the State aid regulation 7

3. Strengths and weakness of bail-in 8

4. The marketing of subordinated debt: need of restricting it or making it more informed? 11

References 13

LIST OF ABBREVIATIONS

BRRD	Bank Resolution and Recovery Directive
CET1	Common Equity Tier 1
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation

EXECUTIVE SUMMARY

The crisis has profoundly changed the handling of bank distress. Prior to the crisis, problems at banks were typically solved with the help of public support. The situation changed gradually during the crisis till when, in August 2013, the Banking Communication made clear that banks in need of public support had first to try and raise capital by private means through the "bail-in" of junior private creditors. This new concept constituted also one of the main pillars of the subsequent regulations on bank resolution introduced with the subsequent Bank Resolution and Recovery Directive (BRRD) approved in 2014.

Bail-in can potentially lead to enhanced market discipline and lower use of public finances if its application is credible and stringent. This requires that the holders of bail-in able debt have the capacity of absorbing losses but also that the application of bail-in does is consistent with financial stability. Only if both of these conditions are in place, public funds may not be used to compensate subordinated debtholders for potential losses. Sophisticated investors have typically a larger financial capacity than unsophisticated investors but they are also more reactive to information and/or imposition of losses and are therefore more likely to generate runs and systemic risk. In contrast, retail investors are slower movers and as such they constitute a more stable source of funding.

For these reasons, we do not advocate the ban of the sale of subordinated debt to retail investors. Rather, it is crucial that the rules concerning the marketing of these products are appropriately designed and their implementation is supervised by competent authorities. One possibility could also be to allow retail investors to hold subordinated debt only indirectly through investment and mutual funds. This has the advantage of allowing retail investors to have a more diversified portfolio than when holding single securities directly. Yet, it still requires a substantial investment in financial education to make investors aware of the portfolio the fund invests in and how it changes over time.

1. INTRODUCTION

Starting with 2013 there has been a dramatic shift in the way bank distress has been dealt with. Prior to that date, problems at banks were typically solved with the help of public support. This could take many forms ranging from recapitalizations, impaired asset measures or other forms of support such as public guarantees. In these processes, bank creditors, including subordinated debt holders, had been mostly untouched.

The panorama changed substantially in the summer of 2013 with the new burden sharing rules ("Banking Communication")[1] within the State aid framework. These rules raised the principle of "burden sharing" in that banks in need of public support had first to try and raise capital by private means. These means included external capital raising plans as well as the involvements of existing shareholders and hybrid capital and subordinated debt holders.

The new State aid rules of 2013 represented a radical shift in the management and resolution of bank distress. The main idea behind them was the need to reduce the "bail-outs" by the public sector and move into a regime of "bail-in" by the private sector. This new concept constituted also one of the main pillars of the subsequent regulations on bank resolution introduced with the subsequent Bank Resolution and Recovery Directive (BRRD) approved in 2014 and implemented in January 2016. The directive extended further the range of liabilities eligible for bail-in by including for example, at least in principle, senior debt and even large deposits.

The Banking Communication and the BRRD differ significantly concerning the type of bank liabilities eligible for bail-in, and as such, introduce difficulties and potential confusion in the implementation of the new rules. Notwithstanding the importance of these issues, this article will focus on the concept of bail-in and their application to subordinated debt, without entering into the details of the different regulations. Specifically, we will first describe briefly the introduction of bail-in for Tier 2 instruments within the context of the burden sharing rules, and we will then analyze the advantages and disadvantages of the introduction of the bail-in principle. Finally, we will discuss potential ways to address the critical aspects of the bail-in in terms of financial stability and consumer protection, also concerning the marketing of these instruments and their desirable holders.

[1] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis.

2. THE ORIGIN OF BAIL-IN: BURDEN SHARING RULES WITHIN THE STATE AID REGULATION

During the financial crisis started in 2007, more than 70 European banks representing more than 25% of total banking assets in the European Union were restructured. Till 2013, this restructuring took mostly the form of public bail-outs. Creditors, including holders of hybrid instruments and subordinated debt, were mostly untouched. The decision of conducting the restructuring through public support at the expenses of public finances and at the benefit of private creditors was mostly driven by fears of financial stability and contagion.

Although these fears may have been warranted, at least in the most dramatic moments of the crisis, soon it became clear that the approach of bail-outs was not appropriate in the longer run: it was not sustainable for the public finances of various Member states given the size of some national banking systems and the lack of a European fund for bank resolution; and it was in contrast both with the idea of a healthy, market-oriented banking system and with the need of guaranteeing an adequate level playing field across Member States.

For all these reasons, the Commission decided to strengthen significantly its State aid regulation with a new Communication on 10 July 2013. The new rules introduced higher minimum standards for burden sharing. Essentially, they established three requirements (capital raising measures, bail-in of subordinated debt and measure to prevent the outflow of capital) which needed to be complied before any public support could be allowed (Kerle, 2013). Concerning the bail-in rule, the Communication required that a bank does not manage to raise enough capital, it is obliged to seek contributions from shareholders junior creditors (hybrid capital and subordinated debt holders) first in order to reduce the capital shortfall to the maximum extent possible. Such a contribution can consist in the conversion of the hybrid instruments into CET1 or a write down of the principle of the instrument. In simple terms the new rules responded to the desire to make bondholders share the burden in future bank restructuring by making them forfeit part of their investment to bail in a bank before taxpayers are called upon through bail outs. In theory, this will force them to be more careful with their investments and protect the taxpayer from a re-run of the recent crisis.

The new rules represented an important step in the resolution of the banking crisis in Europe as they represented a systematic requirement of private involvement in dealing with bank distress. They also constituted the basis of subsequent regulations, including the BRRD approved in May 2014. For the purpose of this article, it is sufficient to note the difference of the various regulations concerning the eligibility of the different financial instruments for bail-in: whereas the State aid rules limit the applicability of the bail-in to junior debt, i.e., subordinated debt and hybrid instruments, the BRRD enlarges the eligibility to more liabilities including senior debt and derivative instruments. Notwithstanding the importance of this difference and the implications in terms of level playing field across Member States, we will leave them out from the following discussion and will concentrate on the possibility of bailing in Tier 2 instruments.

3. STRENGTHS AND WEAKNESS OF BAIL-IN

As explained above, the introduction of bail-in responded to the desire to make bondholders share the burden of future bank restructuring by making them forfeit part of their investment to reduce a bank's potential capital shortfall before taxpayers are called upon through bail outs.

The introduction of bail-in has important advantages, at least in theory. First, the fear of being bailed-in should induce investors to be more careful with their investments and protect the taxpayer from a re-run of the recent crisis.

Secondly, the enhanced market discipline should have an effect on bank manager's behavior in terms of risk taking and moral hazard. The removal, or at least the reduction, of the implicit public guarantee to junior debt inherent in a bail-out shall make junior debt more sensitive to risk and, consequently, should provide better incentives to bank managers to undertake more proper investments and assume more adequate levels of risk.

Finally, the less likely is the possibility of implicit public guarantee, the less likely will be the capture risks in the relationships among banks, regulators and politicians.

Moreover, and mostly importantly given the sovereign crisis in place at the time of the introduction of the bail-in, the contribution of private creditors to bank restructuring should also entail a lower need of public resources in the banking sector and should therefore help relax the loop between banks and sovereigns. In other words, a greater involvement of the private creditors in bank restructuring should decrease the need of public money and reduce the strains on public deficits.

Crucially, the bail-in will produce its positive effects in terms of enhanced market discipline and lower use of public finances only if its application will be credible and stringent. For the bail-in to be credible, losses on debt holders must be de facto imposed when deemed necessary.[2] For the application of the bail-in to be stringent, no public funds have to be used to compensate debtholders of the losses eventually borne during the bank distress. This will be possible only if the holders of bail-in able debt will have the capacity of absorbing losses.

If one of the conditions described is not satisfied, the effectiveness of the bail-in regime will be put into question. If junior debtholders are not bailed in when a distress occurs, they will start anticipating that de facto the holders of bail-in able debt may not bear losses when the bank distress materializes. This in turn shifts expectations among investors so that they do not exert market discipline and bank managers are no longer disciplined in their incentives to take risk. This may lead to greater risk taking in the banking sector with the consequence of further need of public support and stress on public finances.

Although there have been a few cases where bail-in has been applied, only time will tell whether bail-in will indeed become a wide-spread feature of the post-crisis financial system. The credibility of bail-in will greatly depend on the identity of the holders of bail-in able debt instruments and which bank will be in distress.

Let us elaborate on this concept in more detail. Typically, financial regulation is considered to achieve two objectives: financial stability and consumer protection. The former refers to the need of

[2] The Communication recognizes two different circumstances in which bail-in can be applied in the absence of other ways to overcome the identified capital shortfall: one in which the bank has a capital ratio above the regulatory minimum but below a certain threshold set by the competent authority or by the resolution authority (e.g., pillar 2 requirement in the context of a stress test) and one in which instead capital is below (Kerle, 2013).

avoiding systemic risk and contagion in the financial sector. The latter refers to the need of guaranteeing some protection of savings, in particular those of households.

The objective of having a sound financial system justifies the existence of capital requirements and other micro- as well as macroprudential regulatory tools. Other instruments such as safety net mechanisms, and in particular deposit insurance, are often perceived as ways to achieve financial stability but also consumer protection. In line with this, deposits under a certain thresholds are guaranteed and exempted by any application of the bail-in principle.

Bail-in is a regulatory tool as it aims at enhancing market discipline through better monitoring by investors. This should in turn improve bank managers' attitudes towards risk. Under these assumptions, bail-in achieves both financial stability and consumer protection as it shall reduce the overall risk of the financial sector.

This argument has, however, important flaws. To have an effective market discipline, bail-in able debt should be in the hands of sophisticated investors such as institutional investors, other banks, insurance companies and alike. These investors are best positioned to acquire information and react by withdrawing their funds or requiring higher returns to their investments in case the collected information casts doubts on the future prospects of the bank they have invested in. However, precisely because of this better knowledge and active monitoring, the sensitivity of their decisions is enhanced. This means that sophisticated investors are better than other types of debtholders in acquiring information but also faster in reacting to the arrival of potential negative information on bank future prospects. This may make the application of bail-in on securities held by sophisticated investors more complicated: sophisticated investors can be very reactive to the imposition of losses or even only to the prospects of being involved in a bank restructuring. This increases the probability of sudden sales of bank debt instruments that are anticipated to be eligible for bail-in, thus increasing the volatility of bank valuations. In turn, and especially if the bank debt eligible for bail-in is in the hands of financial institutions such as banks, this may lead to important concerns of increased contagion and systemic risk.

The idea that the application of bail-in can lead to concerns of contagion and systemic risk is recognized also in the legislation. In fact, an exception to the implementation of bail-in is foreseen in case this would endanger financial stability or lead to disproportionate results (point 45 of the Communication).[3] This situation is, in our opinion, to be more likely when the bail-in able debt is in the hands of wholesale investors and the distressed bank is large. It is in fact well known that financial institutions amplify shocks because they are connected through numerous channels ranging from real exposures in the payment systems and interbank market to more information-based channels of propagation.

From the perspective of financial stability, it would therefore be better if the bail-in able debt was in the hands of retail investors. This is not because they don't withdraw their funds, but rather because they tend to respond more slowly than institutional investors to the arrival of negative information about their bank or the banking system in general. Moreover, the household sector lacks the amplification mechanisms typical of the financial sector.[4] This raises, however, the important

[3] A similar idea is contained in the BRRD. For example, according to art. 44, paragraph 3(c), the resolution authority may exclude certain liabilities from the application of bail-in when "the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion".

[4] Recent events for example in Greece in 2015 show that retail depositors do indeed withdraw their funds. Moreover, given that European banks tend to heavily rely on retail deposits in their funding structure, the massive withdrawals of retail investors may cause systemic effects. Differently from the institutional investors, however, retail investors tend to react more slowly (and perhaps also less rationally) than sophisticated investors. This is why a funding structure based on retail investors is typically considered to be a more stable than one based more on wholesale funding.

concern of consumer protection, especially in the transition period we are experiencing given that the bail-in applies retroactively to pre-existing securities that were sold in a very different legislative and political period in which bail-outs were predominant.

The recent events of banks in distress in Italy are a good example of the problem of consumer protection that can arise in the application of the bail-in principle to pre-existing securities held by retail investors. What we are observing is de facto an unravelling of the bail-in principle: the bail-in is applied on subordinated debt held by retail investors; this raises important issues of consumer protection (but not financial stability, also because banks in distress are of small size) so that the government is forced to step in and indirectly compensate the affected investors with public finances.

4. THE MARKETING OF SUBORDINATED DEBT: NEED OF RESTRICTING IT OR MAKING IT MORE INFORMED?

The recent happenings in Italy highlight the complications inherent in the application of bail-in from the perspective of consumer protection and the need for a proper marketing of these instruments.

Here we see two distinct questions: should bail-in able debt be banned to retail investors all together? Or should subordinated debt be sold to retail investors and in this case, how should it be marketed? We believe that both of these questions are a bit misplaced precisely because the application of bail-in cannot simultaneously achieve both the objective of financial stability and of consumer protection.

As explained above, from the perspective of financial stability, subordinated debt should be in the hands of retail investors. Thus, it should not be banned. However, from the perspective of consumer protection, it should rather be in the hands of wholesale investors. This already shows the important contradiction implicit in the construction of the principle of bail-in which may call for a radical change of the whole principle.

Leaving this aside and assuming that bail-in will remain in place, perhaps the best solution would be to have a mixture of institutional investors (possibly not banks) and retail investors holding the eligible securities. This would create some protection in terms of financial stability and would also restrain the problem of consumer protection.

Concerning retail investors, the MiFID (Directive 2004/39/EC) requires that they should be clearly informed about the risks of the financial instruments they are offered and that banks and investment firms have no conflicts of interest when selling a particular financial instrument. Assuming this is possible, it is then the investors' decision whether to undertake the risks implicit in the subordinated debt. The current regulatory framework will be further strengthened with the adoption of the MiFID II/ MiFIR framework. Under the new rules, national authorities will also have the possibility to prohibit or restrict the sale of a particular instrument for reasons of investor protection concern.

In practice it is not clear that the new regulation will be able to address all the critical aspects involved in the sale of subordinated debt to retail investors. Beside better information of the risks implicit in subordinated debt, it is important to solve the typical conflict of interest between banks and clients in the choice of investments that de facto still persists. That is, it has to cease the bad habit of numerous banks of placing bonds of the same bank among the clientele in order to facilitate the funding of the bank itself and possibly increase fees. Second, it has to be greatly improved financial literacy both among bank employees and investors. This requires an important process of financial education, and possibly the creation of apposite authorities geared towards consumer protection. In this sense, it is desirable that supervisors and resolution authorities are more involved in consumer protection.

Another possibility would be to allow retail investors to hold subordinated debt only indirectly through investment and mutual funds. This has the advantage of allowing retail investors to have a more diversified portfolio than when holding single securities directly. Yet, it still requires a substantial investment in financial education to make investors aware of the portfolio the fund invests in and how it changes over time.

A credible introduction of bail-in requires much more than a proper marketing of subordinated debt. It requires a radical shift in the governance of banks, in their internal control system and risk management in order to achieve a more prudent management of the bank and thus, ultimately, lower losses for the investors and the system overall.

This brings us to our last point: we have claimed above that from the perspective of financial stability it is more desirable to have retail investors holding subordinated debt. Although it is at odds with consumer protection, this ensures that the system is less subject to shocks and amplification mechanisms. Wholesale investors are in fact more reactive to any potential signal on their bank's prospects. And, in particular when the holders of subordinated debt are banks or leverage institutions, there is a risk of amplification of the shocks and thus of contagion and systemic risk.

Still, wholesale investors are more sophisticated and thus more able to acquire the information needed to exert an effective market discipline on banks and their risk attitudes. From this perspective, it is clear that wholesale investors – and not retail investors – should hold subordinated debt. How to reconcile this with the fear of systemic risk? There are many ways of achieving this. One possibility is to strengthen further the resiliency of banks via higher capital requirements or similar regulatory tools. Another one is to set up proper firewalls, including fiscal backstops. Theory teaches that as long as banks are subject only to liquidity risk, setting up firewalls in the form of public guarantees or money injections can be very effective in stopping panics and restoring confidence without at the same time entailing any loss for the public finances. This does not mean to go back to the use of bail-outs. Rather it means constructing a resilient financial system able to absorb shocks and able to build and maintain investors' confidence. This is not an easy task. But probably it is more important than asking the specific question on the marketability of bail-in. If Europe wants to build a resilient banking system, a system in which wholesale investors exert market discipline under the (credible) threat of bail-in and retail investors are confident that their savings won't be put at risk without them being aware of the possibility this happens, it needs to undergo a more radical shift and finally think of building a more integrated fiscal economy where potentially losses are mutualized and the fiscal backstops are enhanced.

The creation of the banking union created the chance of doing it. But the limited size of the newly created Resolution Fund indicates that the political willingness is not there yet. Without this, bail-in is likely to remain a theoretical concepts or something applied only to retail investors of small banks. The Italian case is a good example.

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