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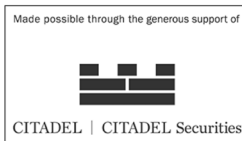
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# Beyond Loss-Absorption in Bank Resolution: the Essential Role of the Composition of Bail-Inable Investors

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Bank resolution is a cornerstone of the regulatory architecture that emerged in the aftermath of the global financial crisis. Its core aim is to orderly resolve distressed banks allocating losses to banks' insiders (bail-inable creditors) and avoiding bailouts. The first years of the resolution regime in the EU disappointed



many. To this date, the only resolution case was Banco Popular, a Spanish bank then acquired by Banco Santander. In contrast, several distressed banks were saved or liquidated with different tools, including the resort to public funds.

In the quest for a credible resolution regime, building sufficient ‘loss-absorbing capacity’ in good times is key (FSB, 2015). To this end, in the EU, the Bank Recovery and Resolution Directive (BRRD) requires compliance with a Minimum Requirement for Own Funds and Eligible Liabilities (MREL), ie liabilities that can ‘absorb’ losses in resolution.

In a recent article (JCLS, 2021), I argue that the concept of ‘loss absorption’ may be misleading as losses do not magically vanish but are rather allocated to investors holding bail-inable securities. The article demonstrates the importance of identifying investors in bail-inable securities (ie who is going to bear losses) as their composition is essential for the effectiveness and credibility of the resolution regime and the application of the bail-in principle.

First, the characteristics of bail-inable creditors matters from the perspective of corporate governance. Such creditors should monitor closely banks’ risk-taking as they bear losses contingent on resolution. However, not all creditors have the ability and willingness to properly monitor. Second, the composition matters from a financial stability perspective, as allocating losses to highly leveraged investors, deeply interconnected with other financial institutions would generate negative spillovers and a risk of contagion, making the bail-in an unworkable option (see Patel & Ringe 2019).

This conundrum cannot be easily solved as no investor can, at once, maximise the disciplining effect and minimise the risk of contagion. In other words, there is no bullet-proof investor in bail-inable debt. Moreover, EU banks are expected to raise a striking amount of MREL (26% or risk-weighted-assets, as estimated by Laboureix, 2017). Thus, even if an ideal investor existed, it would not suffice to satisfy the quantitative requirement. In my article, I refer to this as the ‘existence constraint’.

Building on this framework, I study the composition of investors in bail-inable debt in five Euro Area (EA) countries (France, Germany, Italy, the Netherlands, Spain), using the public data of the Security Holding Statistics compiled by the ECB. The analysis looks at the evolution of the composition of bail-inable debtholders between 2013 and 2017 and reveals a transition towards a more desirable composition of investors, even though considerable room for improvement remains.

The data shows that banks place bail-inable debt mainly to EA-based investors (82% in 2013 down to 67% in 2017). This already decreases the credibility of resolution. Anecdotally, a considerable share of non-EU holdings represented one of the key elements in the ‘proto resolution’ of Cyprus banks in 2013 (Zenios, 2013).

The analysis also reveals that investors are adjusting to the new resolution framework with an increasing share of institutional investors, a relatively stable involvement of other banks and a sharp decline in retail investors’ holdings. However, severe heterogeneity persists across countries and path dependency hinders the creation of a level playing field among European banks. For instance, resolving an Italian bank would allocate losses mainly to households and other banks, as they cumulatively hold 75% of the outstanding bail-inable debt. In contrast, by the end of 2017 the same type of investors only held 46% of bail-inable debt issued by Dutch banks. Clearly, similar resolution decisions for banks failing in equal circumstances bring about sharply different consequences.

Based on both the theoretical framework and the empirical evidence, it is possible to enucleate some functional characteristics of an ‘optimal composition’ of investors in bail-inable debt. It is a mixed composition that maximises the disciplining impact on the borrowing bank and minimises the threat to financial stability while being able to satisfy the ‘existence constraint’.

To this end, bail-inable securities are grouped according to the seniority of the claim. Senior claims should be held by categories of creditors with deep pockets, such as pension funds and other banks, even though they might pose considerable stability concerns. Notably, in contrast to the majority of the literature, I argue that bank crossholdings should not be completely ruled out since they are unavoidable for satisfying the ‘existence constraint’.

On the other hand, sophisticated investors that are able and willing to influence the bank management should hold junior claims. Specifically, it should be a mix of active investors, such as activist hedge funds, specialised active funds, such as mutual funds that actively invest in a vast array of bail-inable securities, and indexed investors, that invest horizontally in all securities.

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