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Martino, E.

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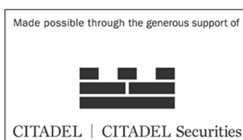

Bail-in beyond Unpredictability: Creditors' Incentives and Market Discipline

Author(s) **Edoardo Martino**
Postdoctoral researcher at the Amsterdam Center for Law & Economics (ACLE) and a research associate at the European Banking Institute

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More From: Edoardo Martino

Resolution of distressed banks represents one of the major cornerstones of the post-crisis financial regulation. It should let shareholders and long-term unsecured (bail-inable) creditors bear the losses of bank failures and allow for an orderly solution of the crisis. The bank is internally recapitalised, avoiding bail-outs (FSB, 2011). Consequently, long-term creditors should have incentives to actively monitor their borrowers and enhance market discipline.

In a recent paper (EBOR, 2020), I show that bank creditors cannot be expected to efficiently discipline their debtor under the major European resolution framework. This is not only because of the unpredictability of resolution outcomes but, more fundamentally, because of the legal design of the Bank Recovery and Resolution Directive (BRRD). The paper also demonstrates that this result is ultimately rooted in the competing policy objectives that the Directive pursues.

The ability of bank creditors to efficiently discipline their borrower is a recurrent topic in the legal and economic literature in banking (for a recent and comprehensive review, see Bliss and Flannery (2020)). In fact, the highly leveraged, procyclical and systemic nature of banks provides shareholders with incentives to engage in excessive risk-taking, increasing systemic risk (Armour and Gordon, 2014). Thus, creditors disciplining such behaviour may considerably increase social welfare.

Theoretical expectations posit that bail-inable creditors should have optimal incentives to monitor their borrowing banks, reducing their risk-taking appetite and minimising the probability of suffering losses. Nonetheless, many commentators argue that the lack of credibility and excessive complexity of the resolution mechanism impair the ability and willingness of creditors to exert a disciplining role (Tröger, 2018 and 2019).

Monitoring banks is costly and requires considerable efforts. Thus, creditors can be expected to monitor their borrowers so long as, at the margin, the expected benefits outweigh the cost of monitoring. Creditors' expectations of future losses in resolution represents the pivotal element. The higher the expected losses, the higher the willingness to invest in costly monitoring to avoid those losses. Crucially, expected losses depend on the probability of resolution and the existence of external elements shielding creditors from losses, such as bailouts.

Based on this simple economic reasoning, I contend that the inability of bail-inable creditors to exert efficient discipline is rooted in the legal design of the BRRD. Specifically, the paper shows that the 'no creditors worse off' rule (NCWO) and the rules on granting public aid impact on creditors' incentives and decrease the expected benefits of monitoring.

The NCWO rule postulates that creditors cannot incur greater losses in resolution than those they would have incurred if the institution had been liquidated. In such scenarios, bail-inable creditors are entitled to ex-post compensation (Articles 34(1)(g) and 74 of the BRRD). If bail-inable creditors expect to be partly shielded by the NCWO, the expected benefit of ex-ante

monitoring decreases, making their effort suboptimal. The other side of the coin is that the NCWO rule also provides incentives for opportunistic litigation ex post (ECJ, *Algebris* case—pending).

A similar effect materializes if creditors expect that—despite the no-bailout commitments—some form of external financial rescue will nonetheless happen. The paper widely discusses the rules allowing public interventions after 8% of the total liabilities are bailed-in (Article 37(10) and 56 of the BRRD).

Similarly, the incentive to actively monitor borrowers and enhance market discipline can be diluted in the case of a precautionary recapitalisation. Thereby, a Member State injects fresh capital in a solvent bank that failed a stress-test, as happened to the Italian bank Monte dei Paschi di Siena (Hadjiemmanuil, 2017). If creditors expect that a precautionary recapitalisation will happen, the ex-ante monitoring incentives dramatically decrease.

These results are dense of policy consequences. A repeated and consistent application of the resolution powers may solve the problem of unpredictability in the foreseeable future. Yet, efficient market discipline would still not be achieved and, accordingly, supervisors and regulators should not rely upon it.

Finally, the paper argues that the inherent dilution in monitoring incentives derives from the competing policy objectives the BRRD pursues. 'Maintaining market discipline' and 'minimising reliance on extraordinary public financial support' are expressly mentioned as resolution objectives by Article 31(2). At the same time, the protection of property rights via the NCWO rule represents an external limitation on the constitutionality of bank bail-ins (ECJ, *Kotnik* case). Even though 'the resolution objectives [should be] of equal significance', the legal design of the BRRD and resolution practices lean toward the absolute primacy of the stability considerations.

In conclusion, the enthusiasm for the disciplining capacity of the new resolution framework has been misplaced, or at least overemphasized. Given the current regulatory framework, expecting creditors to carry out efficient market discipline, now or in the foreseeable future, remains little more than a dream.

Edoardo Martino is a research associate at the Amsterdam Center for Law & Economics (ACLE) and researcher at the School of Law, Erasmus University Rotterdam.

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