AUSTRALIA AND NEW ZEALAND SHADOW FINANCIAL REGULATORY COMMITTEE

STATEMENT No. 13

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MELBOURNE

Bail In: Not a Panacea

In this statement the ANZSFRC examines the potential for regulatory requirements for systemically important banks to issue "bail-in" securities to assist in preventing financial crises. While the Committee believes that high total loss absorbing capacity (TLAC) is desirable, it is concerned that achieving that by use of bail-in securities may, if bail-in occurs or is likely, aggravate crisis situations. The Committee is also concerned that investors in bail-in securities are inadequately informed regarding the risks involved and recommends that better disclosure is urgently required. Bail-in securities might enhance market discipline and improve managerial incentives (particularly if bank remuneration were linked to performance of bail-in securities). However we are not convinced that there are net benefits from requiring issue of bail-in securities rather than higher core capital.

Requirements for large systemically important banks to have higher total loss absorbing capacity (TLAC) which can be met by the issue of contingent capital instruments (debt/hybrid securities which are "bailed-in" (ie convert into equity, or are written down) when the issuing bank strikes trouble) are soon to become a reality. There are several objectives. The political one is to prevent the government "bail-outs" of troubled banks with their consequent costs to taxpayers. A second objective is to try and prevent the failure of systemically important banks (and economic disruption) by recapitalisation. Bail-in also facilitates an improved allocation of losses in the case of failure, where the authorities have to step in and resolve the bank. A third objective is to increase market discipline of bank management by creating a new class of stakeholder who will bear the consequences of excessive risk taking by banks.

The origins of international support for such requirements can be found in the Global Financial Crisis when a number of bail-outs imposed costs on taxpayers (although not in those cases where banks recovered quickly and generated profits for government owners). Also, holders of debt included in regulatory capital were protected from loss by such bail-outs, despite being expected to absorb losses in the event of bank failure.

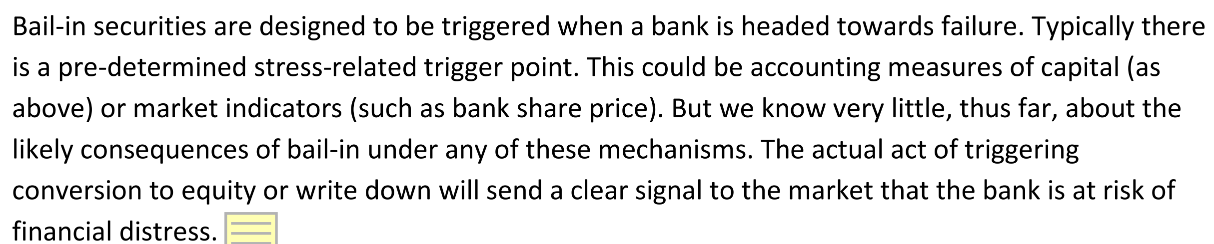
Regulatory pressure for bank issuance of "bail-in" securities comes as part of international proposals for a TLAC requirement for globally systemic banks (which APRA will also apply to the major Australia banks). The Financial Stability Board issued a consultative document in November 2014, and will bring to the G20 Summit in November 2015 final proposals requiring TLAC of over 16 per cent of bank risk weighted assets. The TLAC requirement incorporates within it the Basel regulatory capital requirements, and there is a general expectation that the gap between the two will be largely met by "bail-in" securities rather than additional common equity.

Two features of these proposals warrant comment. First, to the extent that TLAC only applies to large systemically important banks, it may affect competition – arguably reducing benefits such banks gain from perceptions of "too big to fail" and implicit government guarantees. *ANZSFRC does*

not see any reason to extend this regulatory TLAC requirement to smaller banks and ADIs. Second, the proposals add another layer of complexity to already highly complex bank regulation, on top of existing RWA based requirements and proposals for introduction of a leverage ratio and capital floors for large banks.

"Bail-in" securities are already on issue in Australia and New Zealand, since they can be included as additional tier one regulatory capital. Major, and other, banks have issued converting preference shares or capital notes which are characterised by a requirement that they convert into equity (or are written down) if the bank's common equity tier 1 (CET1) ratio falls below 5.125 per cent, or if APRA declares that the bank is at risk of non-viability. If either of these "triggers" occurs, the bank is recapitalised to the cost of existing equity holders (via dilution) and/or the holders of the bail-in securities depending on the conversion arrangements. A trigger event does not currently have any specified consequences for governance of the institution, but ANZSFRC would, in the absence of voluntary action, expect supervisors to intervene.

Bail-in securities are designed to be triggered when a bank is headed towards failure. Typically there is a pre-determined stress-related trigger point. This could be accounting measures of capital (as above) or market indicators (such as bank share price). But we know very little, thus far, about the likely consequences of bail-in under any of these mechanisms. The actual act of triggering conversion to equity or write down will send a clear signal to the market that the bank is at risk of financial distress.



The consequences of triggering bail-in should provide strong incentives for shareholders and managers to ensure prudent investment and risk management by the bank, and thus lower the likelihood of the trigger point being hit. But a bail-in may ironically sound the bank's death knell rather than providing a lifeline for the bank, because of the impact on reputation and confidence.

In normal times, confidence in bank management will result in low perceived probabilities of bail-in for a particular bank being triggered, as will evidence of sound regulation and pro-active supervision of the whole banking sector. It is likely that banks approaching the trigger point and still able to issue equity capital, will do so to avoid the negative consequences of conversion (and be "encouraged" to do so by supervisors). For banks that cannot issue equity to avoid bail-in occurring, the bail in event may be a clear signal that the bank is on the brink of failure.

In general, bank reactions to TLAC involving "bail-in" securities have been less adverse than to suggestions for higher equity based capital requirements. This reflects a perception that "bail-in" securities will be less costly than equity. One explanation for that is tax – in other countries classical tax systems involve an interest tax shield for debt type instruments which reduces the cost of debt relative to equity. This is less relevant for Australia, because of dividend imputation, and explains why preference share structures rather than debt instruments have been used in many cases for "bail-in" securities.

A second explanation is that banks perceive that they can issue such securities relatively cheaply compared to equity. That could reflect investor expectations that the "trigger" will never be pulled (due to prior regulatory intervention to ensure increased capital buffers or political trepidation to bite the bullet and force conversion) and that there is thus little need for higher returns to compensate for this risk. Or it could be that investors do not really understand the risk and thus do

not demand adequate compensation. With retail investors having been the main target market of existing bail-in securities, that is not unlikely, and raises the question of investor protection and advice associated with such complex securities. In the UK, the regulators have imposed a temporary ban on marketing of such products to retail investors.

The ANZSFRC does not believe that it is necessary to follow the lead of the UK regulators and prevent sales of bail-in securities to retail investors, but is very concerned that the clarity of information provided to investors regarding the risk and consequence of "bail-in" is inadequate. We therefore recommend some standardisation and improvement of disclosure requirements which, if the banking industry does not implement, should be examined by the Australian and New Zealand regulators.

That these instruments are difficult to understand is illustrated by the capital notes issued in New Zealand by one of the four major Australian bank subsidiaries. These perpetual notes are to be converted into equity in the Australian banking group if the common equity capital ratio of the subsidiary in New Zealand or the parent banking group in Australia falls below 5.125% or if either is deemed 'non-viable' by the respective regulators, the RBNZ and APRA, to the extent necessary to provide recapitalisation to restore the 5.125% level for the subsidiary or parent or return them to viability. They must also be converted if there is a change of control of either the subsidiary or the parent and they are callable by the bank itself on specific dates or in the event of tax or regulatory shocks, when they may be converted into shares in the parent or redeemed – the latter being dependent on RBNZ agreement because the overall Tier I ratio must not fall below the acceptable level and quality.

The complexity is even greater if the New Zealand subsidiary enters statutory management and the manager decides upon Open Bank Resolution (OBR), which is New Zealand's "bail-in" mechanism. If the notes have already been converted into equity in the parent then they will not be subject to writing down but if they have not then they will be first in line to be written down, along with the equity held by the parent. The speed at which the subsidiary gets into difficulty, the extent of problems with the parent group in Australia and the decisions of both the RBNZ and APRA all affect the outcome, providing complex incentives for all parties. Yet these notes were marketed as retail instruments, considered as higher yielding bonds. While the risk that these bonds might be triggered may have seemed trivial at the time of their issue, that risk might change at some time in the future. Open Bank Resolution already has the difficulty that ordinary depositors are junior unsecured creditors in New Zealand and hence second in line to be bailed in after the shareholders and capital note holders. Thus while the first loss is borne by the parent in Australia, losses thereafter will quickly fall on ordinary people in New Zealand rather than on other financial and commercial institutions who may be better able to bear losses. It is therefore not clear whether bailing in this way will either have a less severe or more equitable impact on the real economy or advance a crisis by triggering a bank run. One advantage of issuance of contingent capital in the New Zealand context is that it may reduce the likelihood of the need to activate OBR.

Excessive risk taking by banks is a critical concern to regulators – particularly when it comes to the systemically important financial institutions (SIFIs) within their jurisdiction. The ANZSFRC believes that remuneration policy (as part of a big package of mechanisms) should not be forgotten as another potentially important channel through which this moral hazard concern can be ameliorated. Indeed, the focus on TLAC and the special role of bail-in securities presents a new

perspective/opportunity on remuneration – one in which executives can be incentivized to consider the goal of capping risk (for the greater good), as an offset to the traditional focus on profits (aided by the moral hazard of a "too big to fail" world). *ANZSFRC recommends that (with the meaningful encouragement of regulators) bank boards seriously consider how future bank executive remuneration packages can be designed to incorporate a dimension that rewards the maintenance of a high market value of any bail-in securities on issue.*

Appropriately designed, such a focus would serve to keep a balance of rewarding profit in a socially responsible way that recognizes the societal externality arising from being a systemically important institution.

The idea behind bail-in is that the recapitalisation will enable ongoing viable operations of the bank, but pulling a hard trigger of conversion or write down may only give a "dead cat bounce" if confidence is undermined. In principle, bail-in securities simply reallocate losses in troubled banks among stakeholders (including taxpayers), but we know virtually nothing about how holders will respond if the risk of bail-in is near, or what reactions an actual bail-in will cause. The potential for contagion (well beyond the banking sector and affecting institutional investors) and amplification of problems, particularly in a crisis, is unknown. What is critical is effective supervisory intervention or management action well before the hard trigger is reached – to ensure adequate capitalisation and avoid the hard trigger.

Contingent capital may work in an *ex ante* sense as a disciplining mechanism, but is untested in an *ex post* sense where a trigger has been met and may not achieve the objectives set out earlier. In that regard, is it as good as simply requiring higher equity capital?

Members of the ANZSFRC at the meeting which produced this statement were:
Professor Christine Brown (Monash University)
Professor Kevin Davis (University of Melbourne and Australian Centre for Financial Studies)
Professor Robert Faff (University of Queensland and Australian Institute of Business and Economics)
Professor David Mayes (Auckland University)
Professor Deborah Ralston (Monash University)
Professor Michael Skully (Monash University)
Professor Alireza Tourani-Rad (Auckland University of Technology)

The Australia-New Zealand Shadow Financial Regulatory Committee meets approximately twice every year in one of the major cities in Australia and New Zealand. The 'shadow' function of the ANZSFRC is related to the Committee's purpose of following and analysing critically the existing and evolving regulatory framework for financial institutions and markets. At the end of each meeting the ANZSFRC issues a public statement on topics discussed during its meeting and presents this at a conference or briefing session. The Committee is fully independent of the providers, regulators and supervisors of financial services whose behaviour it aims to evaluate. Previous statements of the Committee can be found at: http://www.australiancentre.com.au/ANZSFRC

Analytical Mission
The analysis of the regulatory framework is based on existing and proposed national regulations in Australia and New Zealand, recommendations by international forums such as the Basel Committee and the Group of Thirty, and on relevant academic research in this field. Typically, the Committee tries to translate concepts drawn from academic literature into concrete policy recommendations with respect to certain subject areas.
Worldwide Network of Shadow Committees
The ANZSFRC is part of an emerging worldwide network of Shadow Financial Regulatory Committees (SFRCs). Once every year or two years the Shadow Committees of Asia, Australia-New Zealand, Europe, Japan, Latin America, and the United States meet in a major international city to discuss a theme of common interest, resulting in a joint policy statement. The last joint meeting took place in Tokyo in October 2013.