FSB bail-in review: Mind the gap

Speaking at the Exchequer Club on 7 July, US Federal Reserve Vice Chairman for Supervision Randal Quarles, who also chairs the Financial Stability Board (FSB), demanded bank regulators globally step up their efforts to prepare for a new financial crash, specifying that all jurisdictions of the FSB urgently "need to implement resolution reforms and to improve their resolution capabilities so they are fully prepared to respond to a bank failure or a crisis".

Twenty-five central banks comprise the FSB, which is a unit of the Basel, Switzerland-based Bank for International Settlements. Those nations, which include Australia, signed up to implement a global "resolution regime" at the post-Global Financial Crisis G20 summit in London in April 2009. The bank resolution process was supposed to force banks to behave better by taking away the prospect of government- (i.e. taxpayer-) funded bailouts in a crisis. It imposed new standards for bank capital ratios and loss absorbency capacity, along with an enhanced supervision regime which would include giving regulatory agencies the power to take over a bank in crisis and confiscate investments and deposits to recapitalise the bank in order to keep it functioning, in order to protect the stability of the overall banking system.

"The benefits of reforms cannot be realised unless they are operationalised", Quarles insisted, drawing attention to a new FSB "consultation report" which shows many member nations have failed to implement the crisis reforms. For many nations, some powers are still under development, partially implemented, non-existent, or agreed but not yet in force. In other words, there is a gap between what they have pledged and what has been delivered. Additionally, as seen in many cases in Europe, even once bail-ins have been executed, there is usually more work required to refine the technical process.

Despite this, the 28 June report titled "Evaluation of the effects of too-big-to-fail reforms", claims "significant progress". One gem from Quarles's "evidence" for the effectiveness of the reforms is that investors believe that banks in trouble are less likely to be bailed out, because they will undergo resolution. Another is that "Recovery and resolution planning has improved banks' capabilities to produce timely, accurate and granular information". On the downside, however, all that extra information shows that "systemically important banks remain very complex", admitted Quarles.

For reforms to succeed, the report states, "Governments must have the powers, the information and the incentives to move from bailout to bail-in". Bank behaviour must be impacted by the threat of bail-in; the market must be informed of this shift, to "price" those changes; and "mechanisms must be sufficiently strong to affect aggregate outcomes".

An appendix on "The elements of resolution reforms" reviews the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions, which catalogues the mechanisms to be adopted by member nations. Resolution regimes "should include a broad range of powers and options" to enable banks to be resolved efficiently. Powers to take over firms, transfer assets and liabilities, and conduct a bail-in by writing down or converting liabilities are crucial. "These powers should be available under the legal framework", states the document, "for the purposes of resolution and exercisable *without the consent* of shareholders, creditors, debtors or the firm in resolution." (Emphasis added.)

The FSB introduced in the report a new index to show the progress of reforms. Named the Resolution Reform Index (RRI), it measures whether nations live up to the Key Attributes across three areas: With 0 being not implemented at all and 1 being fully implemented, Australia ranks at 0.9 in index 1 (recovery and resolution planning); 0.03 in index 2 (policy and guidance framework for resolution); and 0.3 in index 3 (loss absorbing capacity and bail-in powers). The high rating in index 1 reflects the extraordinary powers of local regulatory authorities to take over and reorganise failing banks; the low rating in index 2 likely reflects our government's lack of public disclosure of resolution mechanisms (see IMF observation below); and the mediocre rating in index 3 is awarded because the FSB takes the formal, published word of the Australian government that it has not legislated a statutory (legislative) bail-in framework—the index is "based on self-reporting".

The FSB is well aware Australia has a chequered history with bail-in, given that the Citizens Party exposed and stymied the bail-in plans in 2013-15 by organising public opposition, whereas in most other nations which have bail-in powers citizens had no idea they were being enacted. Even once passed in Australia in 2018, the IMF in an appendix to its February 2019 Financial System Stability Assessment for Australia, noted the government's ongoing coyness: "Australia has adopted a cautious public stance on creditor bail-in."

According to the report, Australia has been more compliant than several nations, including India (where bail-in legislation was withdrawn in 2018 due to public outrage, as it closely followed the scrapping of 86 per cent of the currency in a form of cash restriction), Argentina, Brazil, China, Indonesia, Korea, Russia, Saudi Arabia, South Africa and Turkey. Fully compliant nations include EU member nations, Switzerland, Hong Kong, Canada—which is almost there— and the USA and UK.

By Elisa Barwick, Australian Alert Service, 15 July 2020
