Bank bail-in consequences for pension funds, insurers and the consumers dependent on them

A new component of the recovery and resolution framework for banks is the mandatory bail-in of shareholders and unsecured creditors that will become mandatory across the EU at the latest in 2016. The bail-in of creditors has been introduced to avoid having member states (ultimately at the expense of its taxpayers) chipping in to bail out a bank that is too important for its economy to let fail. As a policy choice this is understandable, even if much of the initial investment in bailing out a failing bank is normally recouped when the bank or its assets are sold at a later point in time (unless the public sector owner manages the bank for other public policy reasons than recouping its investment).

For subsets of depositors/investors at banks the new mandatory bail-in at the behest of resolution authorities requires a new mind-set in risk management. Specifically this applies to those depositors holding funds at the bank that are not protected under the applicable depositor guarantee system, such as companies or individuals keeping more than 100.000 euro at the bank, or (from 2019) those that bought bonds issued by the bank.

The new rules aim to the public budget, while continuing to protect small depositors, and anyone with a secured claim on the bank (such as central banks). Really new in this line-up is the protection of the public budget, or as politicians/legislators name it: 'the taxpayer'. Increasing the protection for the public budget does mean that the losses will have to be suffered by someone else, in this case the 'senior unsecured creditors' that used to rely on (1) implicit government support for large banks, (2) good banking supervision that would fail and liquidate the bank when it was still solvent enough to pay back each senior unsecured creditor after the liquidation process, or (3) for bondholders that qualify as consumers or small companies on the explicit deposit guarantee system for bond portfolios up to 100.000 euro. These are all in the process of being removed, as senior unsecured creditors will no longer be protected under any of them but instead will be forcibly bailed in when there are signs that the bank might be in trouble. The thinking is probably that very wealthy individuals will ultimately bear these costs, but in practice the impact is more likely to be suffered by pension funds, insurers, banks, investment funds that hold cash at the bank in their current accounts, have bonds or own shares issued by the bank, or have to replenish deposit guarantee systems that have to cough up the cash under a bail-in. And by the consumers and companies dependent on them of course.

Though the commitments to the pension fund of the employees of the failing bank are protected, any debts to other pension funds or insurance companies are fair game. Regulators can still opt – in an optional and thus non-dependable manner – to exclude bail-inable creditors at the moment of the bail-in if they for instance fear unrest. This might benefit certain senior creditors, but will only increase the burden on the remaining senior creditors that do not get this benefit from the resolution authorities (for instance because they are based in another member state, or are too small to start a crisis if they in turn fail due to writing down the money they had entrusted to the bank).

For bonds, the exclusion from deposit guarantee protection and accompanying bail-in-ability may be somewhat defendable (in spite of the potential financial instability risks of writing down bank bond values), as long as the right risk premium is paid by the bank for this risk. I understand that after downgrades of bank bonds by rating agencies in anticipation of the bail-in instrument, the (ultra low) interest rates on unsecured senior debt have shown an increase in the risk premium paid to investors in such bonds. It is doubtful whether that risk premium is enough to compensate for the de facto highly increased risk that bank supervisors will deem a bank to be potentially in trouble and potentially to cause financial instability, and 'rescuing' the bank by increasing its capital by writing down or converting these bonds. This can and perhaps should be judged part of normal risk management at the institutions investing in such bonds. It could be a conscious assessment by a well-trained lender that the likelihood of such an event is sufficiently low per bank in a diversified portfolio of bank bonds that even at the current low interest rates the small add-on constitutes an acceptable risk premium. Perhaps. For non-deposit protected consumers and non-financial companies that invest spare cash in bank bonds after the deposit insurance expires for bank bonds in 2019 it is unlikely to be as well prepared for.

A risk perhaps less well understood is that any cash held at any bank on a savings/payment/current account (to the extent it exceeds the coverage by the deposit guarantee system or collateral, and thus also constitutes a so-called senior unsecured credit) is subject to the same write down or conversion as unsecured bonds are. For instance, if a pension funds uses one single bank to collect the liquidity needed to make out the monthly payments to its pensioners, it is in fact making a high risk investment in the bank. This high risk materialises if the banks' supervisor and resolution authority decide that the time for failing the bank has come before the order for the transfer to pensioners has been given. The bank will in that case re-open the next Monday as usual, but the cash needed by the pension fund to make the payment to pensioners will no longer be available as such cash was bailed-in. The supervisor/resolution authority may or may not give an exemption to the bail-in, but this would increase the burden for others (and is certainly not a right of the pension fund).

The main dependable exception is if the bank gives collateral to the owner of the cash, in the example to the pension fund. Senior unsecured debt is bail-inable, but secured debt is excluded. This is for instance the case with central bank loans that will be collateralized by sovereign bonds or other acceptable collateral. Other examples are for funds owed in the clearing and settlement process, or in the case of bonds so-called pfandbriefe and other covered bonds (that are secured by specific assets of the bank). Small pension funds and small insurers will normally not have the market power or political power to ensure such security is given to them for payment accounts. If they do not get it, they may be wise to spread their cash holdings over a wide range of banks in order to avoid potentially losing all their cash in one go. They could also seek insurance e.g. via derivatives on the potential that a bank will fail, but that may be costly, and it would need to be certain that the writer of that derivative/insurance is not itself linked to or exposed to the bank that is failing.

Should the shares in a bank, bonds issued by a bank, and savings held at a bank by an institutional investor be bailed in, this may have an impact on its own obligations to pay out. An investment fund will be worth less (and so will the pro rata investments by its investors, and the investors in such investors), which may or may not have been understood by those investing via such a fund. At an insurance company or pension fund it may mean that premiums will need to be increased, or payouts reduced. Though their clients may not always be taxpayers in the country where the bank was based, they will definitely be taxpayers somewhere. Taxpayers will thus still bear the costs directly or indirectly via their pension funds, investment funds and insurance firms. The main change is that this burden will only to a lesser extent arrive via state budgets (which will still contract due to lower tax receipt as a result of the losses suffered by banks, insurers, and individual taxpayers, as well as via bailed-in cash held by municipalities, provinces and other state bodies at the bank). The main advantage is the public relations benefit that the burden will not go via the state budget immediately, and that the costs – if pension funds, insurers etcetera have limited their risks via risk management – will be spread out over time and many consumers. Small increases in premiums or limits to payments are less noticeable than a big headline number of initial investment by the state in a traditional bailout. Saving the taxpayer by bailing taxpayers in (directly or indirectly) does, however, appear to be logically impossible.

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– Recital 1, 5, 8, 31, 67 and art 44, 47, 48, 108, 109 and 130 BRRD directive 2014/59/EU

– Recital 5 and 6 Recast Banking Directive 2006/48/EC (part of the previous version of the CRD)

– Art 27 SRB regulation 806/2014

– Art 1.1 and 1.4 of the currently applicable Deposit guarantee directive 1994/19/EC, and Recital 47 and art 5, 20 and 21 Deposit guarantee directive 2014/49/EU (of which 5.1 sub k on excluding bonds will be applicable from July 2019)

– Italy/Romanelli, EU Court of Justice 11 February 1999, Case C-366/97, §13-15.

– EU Banking Supervision, chapter 4.4, 18 and 19

– Are EU Banks Safe?, chapter 3