Intelligence MEMOS

From: Jeremy Kronick

To: Minister Bill Morneau and Superintendent Jeremy Rudin

Date: December 8, 2017

Re: **The Unintended Consequences of Bail-in**

Bail-in is not nearly as well known a term or concept as its cousin, bailout. But the idea of requiring systemically important financial institutions – usually banks – to issue a special category of debt that converts to equity in times of stress is coming soon. And, there could be unintended consequences in the event of a future financial crisis.

In its simplest form, bail-in involves investors and creditors rescuing banks deemed non-viable. This stands in contrast to bailouts, when, typically, governments rescue banks with tax dollars. Therefore, in asking the question is bail-in better than bailout, the answer appears obvious: yes.

However, there are costs, and one stands out: Bail-in debt will likely make it more difficult for banks to raise equity at exactly the time - financial duress – we want it to happen.

Following the 2008-09 global financial crisis, many developed economies introduced the bail-in regime as a result of highly publicized and highly unpopular bailouts. Under a new Canadian bail-in regime expected to become formal next year, if unexpected losses on assets lead to a fall in capital ratios such that OSFI deems a bank non-viable, and preferred shares and subordinated debt conversion to common equity are unable to bring it back to viability, regulators will have the power to convert senior debt instruments – bail-in debt – to equity.

One of the benefits of such a system – and perhaps its most significant – is that investors who buy bail-in debt supposedly know the risks and are choosing to pay for them. Unlike taxpayers who, pre-crisis, did not know they were on the hook.

However, there are drawbacks to this idea – including one that financial market participants have already thought about long and hard.

Let's play out a scenario from 2008, and ask whether the successful outcome is likely to occur under the bail-in regime.

In December, 2007, a large Canadian bank announced that it had exposure to subprime debt that might require a large charge in its next quarter. While it had hedged its exposure, the hedge counterparties were also in financial trouble. The bank, to its credit, decided in early 2008 that it would be prudent to raise not just the minimum equity to placate markets, but enough to deal with the potential tail risk scenarios. With public confidence that Ottawa would not allow a large Canadian financial institution to fail, investors flocked to the equity issuance at a price well below its pre-subprime exposure price. So, in the end, private equity capital came in and saved a situation that threatened - at least in theory – the viability of a large financial institution.

Now let's play this scenario out with a bail-in regime in place. You are an investor looking at the same situation in early 2008. What do you do? If you believe there is serious risk of capital erosion, to the point of non-viability, at best you avoid buying equity, at worst you short the common equity and buy the bail-in debt instruments, especially if you think the financial institution will do well once bail-in has been triggered. If enough investors do the same, the bank would not be able to re-capitalize with common equity. Share prices would fall further – a vicious circle leading to the bank's collapse.

There are many benefits to avoiding bank bailouts. And it is also true that, post-crisis, Canadian financial institutions are even better capitalized. But threats exist, such as cyber-risk, unlike anything we have seen both in terms of size and speed. The implication is that the potential for non-viability is not such a far-fetched concept, and with bail-in it may be more difficult to stop it. As a result, governments and regulators will need extreme market vigilance to head off any whiff of non-viability.

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