Do Bank Resolution Reforms Reduce the Perception of Too-Big-To-Fail?

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What the paper does

1	The paper investigates the effect of the implementation of resolution reforms on the implicit subsidy of banks across 19 jurisdictions.
2	Measuring banks' government implicit subsidy using equity abnormal returns based on Gandhi et al. (2020)
3	And the premise that securities equally exposed to the same risk factors must have similar expected returns, all else equal.
4	As in Gandhi et al. (2020), the expected return of bank stocks is explained by the three traditional equity risk factors (market, size, and value)…

What the paper does

5	and by an unobservable factor, associated to an implicit governmental protection, which is uncorrelated with the three factor.
6	But the paper also adds three other risk factors : profitability, investments, and momentum (following a to as the augmented Fama-French 5-Factor Model plus Momentum regression)
7	and uses unlevered returns to address the heteroskedasticity in the data particularly for leveraged firms.
8	The paper considers equity on the basis that even if the shareholders are not expected to be bailed-out they benefit from lowers interest rates on deposits and long-term debt.

What the paper finds

1	Resolution regimes affect implicit subsidies and reduce risk taking… But for non large banks only
2	The impact on risk taking is greater in countries that fully adopted resolution regime vs. those that did not fully adopt yet.
3	No impact on risk taking could be identified for large banks
4	bank resolution reforms decrease implicit subsidies in both continents, but the effect is economically and statistically stronger in North America

Although, this effect is mainly driven by non-large banks, as we find no effects for large banks in neither continent.

Comments on the sample / methodology

Resolution is a group matter	Resolution is largely a group matter, so question as to which equity the paper is looking at – that of the resolution entity? That of non resolution entities? Several entities within the same group?
Not all banks are earmarked for resolution	Not all banks are earmarked for resolution – US banks disclose their title one plans, EU MREL banks now also disclose.

Comments on the methodology

Is equity the right measure?

What happens in resolution?	▪ In resolution, shareholders are wiped out and the bail-inable debt holders are converted into equity. ▪ But everyone else is broadly safe – depositors, the majority of senior debt holders – not very dissimilar to a bail-out.
What happens in liquidation?	▪ Only the covered deposits are paid-out or transferred to an acquirer and thus covered in full. ▪ Losses can be imposed on everyone else ▪ Potential discontinuation of access due to insolvency proceedings

The objectives of resolution is not to end too big to fail, but to ensure you don't need public money to maintain continuity of services, minimise economic impact and avoid contagion.

Comments on the methodology

Is equity the right measure?	
TLAC / MREL debt	▪ If the objective is to assess the credibility of the resolution regime, then looking TLAC / MREL debt could be better. ▪ In a resolution, as opposed to bail-out, TLAC and MREL debt are more likely to be exposed to losses. ▪ This would also provide a clearer population of banks.

Further comments on the methodology

Regulation does not mean credibility

- The introduction of a law does not mean that a regime is credible.
- Resolution requires work to be credible both from the banks and authorities.
- Resolution requires either disclosure or a demonstration to be credible.
- Credit ratings can also help assess the credibility of the regime.

eba European Banking Authority

Comments on framework description

- Title I vs. Title II – You skipped over title 1 of the Dodd-Frank Act which is a form of resolution or at least an alternative to bail-out.
- Possibility to inject capital in the US vs. EU – in practice the EU/UK framework is more constraining. In the US, the only condition for injecting capital is political.
- The trigger for insolvency / resolution is not bankruptcy but rather the failure to meet regulatory requirements.
- Scope of countries implementing resolution regime, all FSB members are expected to do so.
- UK Banking Act not UK Bank act

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