Discussion:

Bank Resolution Regimes and Systemic Risk

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Strengths of the Paper

Ambitious paper that poses an important question: Do special resolution regimes (RRs) reduce systemic risk?

Constructs an index of strength of RR, based on compliance with the FSB Key Attributes.

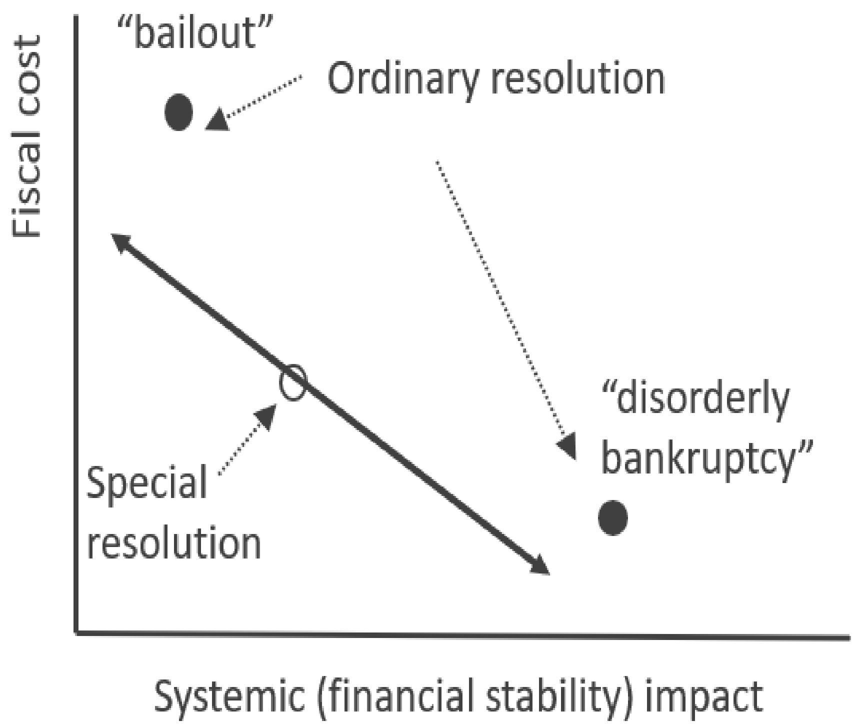
- In the spirit of indices of regulation and supervision by Barth Caprio and Levine.
- Very nice and novel (quibble: could update beyond 2015).

Assesses how changes in (a measure of) systemic risk following market wide and idiosyncratic events are shaped by the strength of RR across 22 FSB countries (diff in diff).

- Analysis is very carefully done.

Tradeoff between Fiscal Cost and Systemic Impact

Figure 1 from Čihák and Nier (2009, 2012)



- Disorderly bankruptcy can create systemic risk.
- W/o special RR, a bailout may be the only way to avoid systemic risk.
- With special RR authorities can explore tools that:
  - Reduce fiscal costs; and
  - Contain systemic risk.

“Bail-in” versus Range of Resolution Tools

Resolution tools aim to ensure continuity of services.

- **Sale** to a stronger institution (Purchase and assumption).
- **Bridge bank** (the authorities take control temporarily).
- **Separation** into a “good bank” (that continues providing services) and a “bad bank” (asset management company).
- **Provision** of guarantees and liquidity backstops for the new/good/ acquiring institution (assisted sale).

Bail-in tools ensure losses borne by existing claimholders.

- All existing **shareholder equity** claims on the failing bank are wiped out, i.e., written down to zero.
- Certain non-deposit **debt liabilities** (subordinated debt) are converted to equity.

Systemic Risk: Definition versus Measurement

Definition: Risk of **disruption in provision of financial services** that is caused by an impairment of all or parts of the financial system and that causes serious negative consequences for the real economy (IMF, FSB, BIS, 2009).

- Can arise from shock to one institution (idiosyncratic shock).
- Can arise from adverse aggregate (market-wide) shock.

Measurement: CoVaR (Adrian and Brunnermeier, 2016)

- $\Delta CoVaR_{q,t}^{system|i} = CoVaR_{q,t}^{system|X^i=VaR_{q,t}^i} - CoVaR_{q,t}^{system|X^i=median^i}$
- Intuition: **Drop in market-wide stock prices** conditional on fall in stock price of one institution.
- This measure is not fully congruent with the definition.

Interpretation of Results (1)

Result 1: Conditional on a **market-wide shock** CoVaR increases more where resolution regimes are stronger.

Can we conclude that stronger RR increase systemic risk? I suggest not.

Alternative interpretation: With stronger resolution regimes, conditional on adverse market-wide shock:

- Bank shareholder **equity is more likely to be written down**, for all banks if the shock is system-wide.
  - All banks' shareholders are saying: "oh no, we are going to lose our shirt!"
- This **need not**, however, **cause a disruption in financial services.**
- Indeed, availability of resolution tools may enable continuity of services.

How could increase in systemic risk be shown?

- Conditional on a market-wide shock, banks' **provision of credit** is reduced more in countries with stronger resolution regimes.
- And this is caused by: yields on subordinated debt increases more, etc.

Interpretation of Results (2)

Result 2: Conditional on a negative **idiosyncratic shock** CoVaR increases less where resolution regimes are stronger.

Interpretation: With stronger resolution regimes in place, spillovers from idiosyncratic shocks are better contained.

- An idiosyncratic shock is less likely to lead to a disorderly bankruptcy.
- This reduces system-wide spillovers—such as increases in funding costs for the rest of the system.
- Also, when the RR helps isolate the issue, other banks' shareholders need not fear bail-in from resolution.

Arguably, this **reduction in systemic impact** is exactly what a special RR is trying to achieve.

Two Final Points

One question: Of the 4 adverse market-wide events, 3 are from the US (Subprime, Lehman, and US debt downgrade).

- This could lead to greater drops in stock prices in the US.

<u>And</u> the US had the strongest special RR at the time of these events.

- This could lead to a bias that attributes the fall in prices to the RR.

Excluding the US (and Japan) is an important robustness test (and already implemented).

Final remark: Application of resolution regimes **can** create additional systemic risk (even in the case of idiosyncratic shocks).

- Most obviously when other financial institutions hold claims on the stricken bank (Cihak and Nier 2009, Eisert and Eufinger, 2018).
- These claims may need to be exempted from bail-in, or their size controlled by macroprudential measures.