

Policy responses to the issue of implicit bank debt guarantees: OECD survey results

by

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Bank regulatory reform is expected to limit the value of implicit bank debt guarantees, even if not plainly targeting such values. According to the responses from 35 countries to a survey on implicit bank debt guarantees, there is however no one specific policy capable of fully eliminating the market perception that bank debt is “special”. A mixture of several different and complementary policy measures is considered more helpful, with recurrent elements including the implementation of internationally agreed capital and liquidity standards, the tightening of micro- and macro-prudential supervision and making bank failure resolution more effective. As regards the overall thrust of bank regulatory reform efforts, most respondents suggest “strengthening banks” and “strengthening the capacity to withdraw the guarantee function” describes best their own efforts. By contrast, labelling certain policy measures as “effectively charging a user fee” is considered problematic as it might make explicit what currently is at most implicit.

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EXECUTIVE SUMMARY

The perception that bank debt benefits from an (implicit) guarantee provided by the government and/or central bank gives rise to a number of economic distortions, including to competition and bank risk-taking, while also potentially burdening the sovereign with contingent liabilities. While the perception of implicit bank debt guarantees might reflect other more fundamental shortcomings such as those in the overall regulatory, supervisory and failure resolution framework for banks, their persistence matters and they create economic costs on their own.

This insight has motivated the OECD Committee on Financial Markets (CMF) to launch a survey process with the express intent to learn from each other i) how to measure the value of implicit bank debt guarantees, ii) analyse the determinants of their value and iii) formulate a policy response that takes into account the effect of bank regulatory, supervisory and failure resolution reform on the value of implicit bank debt guarantees, hopefully limiting it.

A draft survey was discussed and the final version circulated in 2013. By April 2014, responses to the survey were received from 33 OECD members and two key partners, implying a survey response rate of 97% among members. Based on these responses and the discussion by the Committee in April 2014 of a draft report, the current report identifies selected key findings regarding policies that respondents have either implemented or considered that are expected to have a bearing on the value of implicit bank debt guarantees – even if they are not primarily aimed at having this effect.¹ The findings are as follows:

- There is *no single specific policy measure* that could be considered a “silver bullet” capable of fully eliminating the value of implicit bank debt guarantees. While some policy measures are implemented and currently being considered for implementation more widely than others, no single policy is considered by questionnaire respondents to be a panacea.
- Implementing a *mixture of several different policy measures* seems to be considered as offering the greatest promise in reducing the value of implicit bank debt guarantees. In fact, the various specific policy choices are seen as *complementary*, limiting the value of implicit bank debt guarantees through their effects on bank and bank counterparty behaviour.
- Recurrent elements of the mix of policies include the implementation of internationally agreed capital and liquidity standards, the tightening of supervision both in micro and macro prudential terms and efforts to make resolution more effective.
- There seems to be widespread agreement that the value of implicit guarantees ultimately reflects in particular the smooth functioning of exit mechanisms for failing banks. The availability of smooth and effectively operating bank failure resolution regimes implies that the value of implicit guarantees is reduced, as, in effect, the

capacity (and perhaps also willingness) of policy makers to withdraw the guarantee function is strengthened. The conditions of a potential exit are anticipated and determine current pricing and risk-taking.

- A special focus of the discussion by the CMF was placed on three approaches that have been either proposed or are under consideration for implementation, which are to make banks easier to resolve, restrict their business lines, and make implicit guarantees explicit (and charge for them implicitly or explicitly). The discussions and survey responses revealed strong support in favour of the first approach and little for the third, while the second approach received mixed feedback, thus taking somewhat of a middle ground in terms of feedback given.
- To describe the overall thrust of the mix of policies implemented or considered for implementation, three broad categories were distinguished; the overwhelming majority of respondents consider the category “strengthening banks” a relevant description of the mix of their domestic policy choices. Also, a large majority considers “strengthening the capacity to withdraw the guarantee function” a relevant description of the overall mix of measures implemented and, even more so, for those not yet implemented but planned or currently being considered.
- By contrast, the respondents felt uneasy with regard to the suggestion to label certain policy measures as directly or indirectly “effectively charging a user fee” for the provision of the implicit guarantee. Such an approach, while perhaps economically sensible, would make more explicit what currently is implicit and thus it might undermine current active efforts by policy makers to dispel the notion that such guarantees exist.
- As to the issue of what explains the persistence of relatively high values of implicit guarantees on bank debt (see also companion report Schich and Aydin, 2014), respondents noted that the details of the design of bank regulatory and failure resolution reform are still under consideration and various measures have not been fully rolled out, which in part explains such persistence.
- The Committee recognised the need to continue monitoring developments regarding the policies that can be expected to have a bearing on the values of implicit bank debt guarantees and the effect on the values of such guarantees. It was suggested that the Committee could act as a hub for international efforts to better understand the determinants and limit the value of implicit bank debt guarantees.

I. Introduction

This report describes selected key findings regarding policy responses to the issue of implicit bank debt guarantees from the responses to the OECD/CMF survey on implicit bank debt guarantees. The survey focused on i) the measurement and analysis of implicit bank debt guarantees and ii) the policy responses taken or considered by the respondents with a bearing on the value of these guarantees.

The former issues, the measurement of implicit bank debt guarantees and the analysis of the determinants of their values, are covered in a companion report (Schich and Aydin, 2014). One key finding from that report is that estimates of the value of implicit bank debt guarantees are generally not produced on a regular basis, which makes it difficult to analyse and understand the drivers of changes in value over time. In fact, the responses to the survey indicate the need to better understand to what extent the observed recent declines in the estimated value reflect a strengthening of banks, the progress in bank

regulatory and bank failure resolution reforms, an overall declining likelihood of financial distress or declining strength of the sovereign as the perceived guarantor. This situation complicates the formulation of the policy response.

The OECD/CMF survey on implicit guarantees for bank debt also squarely asks questions regarding the policy measures taken or considered by respondents since the pre-crisis period and that may have a bearing on the value of implicit guarantees, even if not primarily aimed at having this effect. In addition, respondents were also asked to assess the potential effect of measures already taken or those considered for implementation, if and once they are implemented. Clearly, even if many of these measures are not exclusively geared towards reducing the value of implicit guarantees, they would be expected to have an effect on the value as they affect the costs, returns and risks of bank business activities.

The present report identifies selected findings regarding the policy responses to the issue of implicit bank debt guarantees. The following second section of the report provides background on the issue of implicit bank debt guarantees, placing a sharp focus on the motivation for policy makers' announced determination to rein in the value of implicit bank debt guarantees, which are the economic costs of (underpriced or even free) guarantees. The third section presents key findings regarding the policy measures implemented or considered by respondents that are expected to have a potential bearing on the value of implicit guarantees. The fourth section singles out three specific and topical types of policy measures for special attention, which are i) making banks easier to resolve, ii) imposing additional structural restrictions on bank business activities and iii) making implicit guarantees explicit so as to facilitate the management of the associated potential contingent liabilities and/or to charge a 'user fee'. The latter issue is taken up again in a different way in the fifth section, which assesses the overall thrust of the mix of policy measures implemented or planned with a potential bearing on the value of implicit bank debt guarantees according to three potential categories, i.e. "strengthening banks", "strengthening the capacity to withdraw the guarantees", and (directly or indirectly) "pricing the guarantees".

II. The issue of implicit bank debt guarantees

CMF discussions on the financial crisis and the policy response to it

With regard to the global financial crisis and related policy responses, the CMF concluded in 2009 that the extension of the financial safety net was helpful, but not without costs. The safety net was extended to cover liabilities of banks that are not traditionally covered by the safety net function, such as e.g. unsecured debt, as well as the liabilities of other financial institutions, such as e.g. those of money market mutual funds, while premiums commensurate with the risk were typically not charged for the extra coverage. Among the costs of this safety net extension are the creation of contingent liabilities for the sovereign, competitive distortions and moral hazard.

In the meantime, the effects of the extension of the financial safety net have become more clearly visible and the issues of perceived implicit guarantees especially for bank debt, potential contingent liabilities, competitive distortions and moral hazard have come into sharper focus.

Initial CMF discussions on the topic of implicit bank debt guarantees were consistent with the view that these guarantees would have to be reined in in order to strengthen

market discipline, although CMF discussions in October 2012 did not reveal any consensus on how best to respond to this situation.

Consequently, the OECD Secretariat prepared under the guidance of the CMF a questionnaire on the measurement and analysis of implicit guarantees and the policy measures taken with a bearing on their value, which was circulated in 2013. By April 2014, responses were received from 33 OECD members and two key partners, implying a survey response rate of 97% among members. The remainder of this report draws both on the responses to the OECD/CMF survey on implicit bank debt guarantees and the CMF discussions of the topic.

(Underpriced) guarantees matter in economic terms even if they are “only” perceived

Not least because of the recent experience with the global financial crisis and the policy response to it, policy makers and the public at large have become increasingly aware that bank debt is “special”. In particular, market participants believe that the debt of many banks, especially – but not only – those considered systemically important, benefits from an implicit guarantee provided by public authorities. The latter may be a local or central government or another public authority, such as a central bank. The perception may exist even if none of these entities has ever confirmed the existence of such a guarantee or, as a matter of fact, expressly denied that such a guarantee does exist. The concept of an implicit guarantee is not straightforward, as the guarantee is not explicit, but implicit. In fact, the possible support for bank debt is only a perceived one.

It turns out, however, that even if the support is only a perceived possible support, it does matter. In fact, an implicit guarantee has an economic value, as is the case for any other guarantee. Even in cases where the presumed guarantor has an expressed intent *ex ante* not to provide any guarantees, subsequent events might make it optimal to renege on such announcements *ex post* and provide support for the debt of banks. As long as it is not possible to definitively rule out such scenarios and the possibility of support, an implicit guarantee will have a value.

Implicit guarantees for bank debt are distortive

A difficulty with such an outcome is that there is typically no charge for implicit guarantees, at least not directly, and as with any guarantee for which there is no adequate charge or fee, this distorts competition and incentives and creates moral hazard. Admittedly, an implicit guarantee also increases the charter value of banks, which could in principle lead banks to take fewer risks to protect future rents. But the evidence in favour of the existence of such effects is in practice quite limited. Rather, most empirical evidence suggests that banks benefitting from underpriced guarantees tend to increase risk-taking.

For example, Marques, Correa and Sapriza (2012) provide a survey and empirical analysis of the relationship between underpriced government support arrangements and risk-taking, which suggests that government support is associated with more risk-taking. Dam and Koetter (2012), using actual cases of bail-outs, show that higher bailout probabilities increase risk-taking. Effects on risk-taking might also be regime-dependent, however. In fact, there is evidence that, during calm periods, higher government-supported bail-out probabilities for bank debt tend to result in higher risk-taking by banks, while during crisis periods banks with higher bail-out probabilities tend to increase their risk-taking less than banks that do not benefit from such support (Damar, Gropp and Mordel, 2012).

The availability of underpriced guarantees tends to create a bias towards excessive leverage and risk-taking by banks, thus giving rise to negative externalities emanating from the banking sector to the rest of the economy in the form of higher probability of default and higher level of systemic risk (Admati et al., 2012). As a result, banking sectors tend to become too large compared to other sectors of the economy, as implicit guarantees distort the allocation of resources. They interfere with the proper functioning of a market economy, as they imply that the profits in good times are privatised, while the losses in bad times are socialised.

The role of market discipline is diminished

Moral hazard arises both at the level of the beneficiary bank as well as at the level of the investors in the debt of that entity. In fact, implicit guarantees for financial institutions weaken market discipline, as the incentives to limit the banks' risk-taking are distorted not only for bank managers but also for bank creditors.

These guarantees immunise banks' creditors against the consequences of default, leading to a lower level of interest rate demanded on bank debt as well as a lower level of incentive for monitoring banks on the part of bank creditors and other counterparties. The powerful role of guarantees and other types of insurance in shaping incentives has been succinctly summarised by Stiglitz (1983) as follows: "*The more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions.*" Empirical evidence is broadly consistent with this hypothesis. For example, recent research shows that market discipline initiates where the probability increases that bank debt holders will incur losses as banks take higher risks, while senior bank debt seems not to be subject to market disciplining effects (Beyhaghi, D'Souza and Roberts, 2013).

Market discipline should however be an essential tool to control risk-taking. In the absence of effective market discipline for financial institutions, an essential tool to control risk-taking is lost, which results in more financial services being produced and consumed than would otherwise be the case. Instead, valuable resources are misallocated, as reflected in the run-up to the crisis in the excessively high profit share of the financial sector. By reducing the value of implicit guarantees, policy makers can strengthen market discipline and help to make sure that resources are directed to more productive uses, which is a key imperative these days.

The ongoing transfer of resources to the banking sector that is implied by the persistence of implicit guarantees for bank debt directly benefits bank debtors but indirectly also holders of the equity of these institutions, as bank funding costs are artificially lowered. While there are valid concerns that banks be adequately capitalised so as to allow them to perform their role in financing real economic activity (especially of long-term projects as well as of activities by small and medium-sized enterprises) and the funding cost advantage provided by implicit guarantees might facilitate equity funding, the cheaper funding does not necessarily translate to cheaper on-lending to fund desirable real activities. More often than doing so, it does not. Again, too many resources are flowing into the sector compared to a situation in which the implicit subsidies are absent.

Implicit guarantees create competitive distortions

Implicit guarantees for the debt of banks create competitive distortions in various dimensions. They tend to favour bank debtors as opposed to other types of corporate

debtors. Moreover, across banks, the value of the implicit guarantee differs from one bank to another, among other things reflecting its size or other features that are perceived as making a bank more worthy of protecting.

In Europe, the close interrelationships between the values of domestic sovereign and banking sector debt is considered undesirable and the recent efforts to advance the European banking union are motivated among other things by an attempt to break that link (see e.g. Gropp, 2014). As has been argued elsewhere, as long as substantial values of implicit guarantees for bank debt persist and the value of that guarantee for a bank systematically continues to reflect the identity and strength of its domestic sovereign, the market believes that not all banks are alike and that some benefit from a more valuable backstop.² In other words, the perception is that there is no common backstop of the same value for all banks and, hence, banks do not compete with each other on a level-playing field.

In fact, the strength of the sovereign is conceptually a key determinant of the value of implicit bank debt guarantees, in addition to the strength (or weakness) of the bank (Estrella and Schich, 2011; Cariboni et al., 2013). When sovereigns in several countries experienced downward credit rating pressures, the stocks of banks considered more likely to receive government support significantly underperformed the broad market (Correa et al., 2012). Thus, the assessment of the decline in implicit guarantees needs to be nuanced. On the one hand, it tends to strengthen the functioning of market discipline. On the other hand, to the extent that it might result from a weakening of the perceived guarantor, the underlying cause is obviously less desirable. Moreover, as long as the strengths of sovereigns differ, additional competitive distortions might arise, with some banking sectors benefitting more from systematically lower funding costs than others regardless of the banks own strength but mainly reflecting the strength of their sovereign (Cardillo and Zaghini, 2012).

Implicit guarantees can have adverse effects on the perceived guarantor and its taxpayers

Implicit guarantees can also increase the value of sovereign debt. In fact, another pressing concern with implicit guarantees in the current environment is the potential adverse effects on the perceived guarantor. These guarantees are seen as creating contingent liabilities for the “guarantor”.

These perceived contingent liabilities can become real contingent liabilities if events force the conversion of the implicit guarantee into an explicit one, and they can become actual liabilities if the bank in question fails to pay its own debt. The experience of some countries with banking sectors that are large compared to the domestic economy have highlighted how quickly banking sector problems can become sovereign problems under adverse circumstances.

Market participants anticipate these risks and charge commensurate costs for the sovereigns’ own debt. In fact, as highlighted by earlier CMF work, the banking-sector-sovereign-debt inter-linkages are understood by market participants. For example, the extent of assumed government support for the domestic banking sector, in addition to actual sovereign debt levels, is taken into account by credit rating agencies in assessing the creditworthiness of sovereigns (Schich and Kim, 2011).

The guarantees are only implicit and perceived by market participants, and thus do not imply direct fiscal costs and are not recognised in the fiscal budget. They nonetheless create potential contingent liabilities for the government that is perceived to be the guarantor.

The fact that they are not recognised in the budget makes it difficult to hold governments accountable for these guarantees. Transparency about actual and contingent liabilities is however an important factor that facilitates accountability and sound decision making. Knowing that the public is aware of decisions tends to instil additional incentives on the part of policy makers to avoid making poor decisions. Obviously, in the present context, the issue of transparency is complicated by the fact that governments – and rightly so – are making various efforts to actively dispel the notion that implicit guarantees for bank debt exist.

When discussing the issue in April 2014, it was suggested that a better understanding of the magnitude of potential fiscal contingent liabilities arising from bank liabilities is an important precondition for an efficient management of such liabilities. But it was also cautioned that putting implicit guarantees more squarely on the government's balance sheet (or including discussions of related potential fiscal risks in budget accounts) runs the risk of crystallising expectations that implicit guarantees do exist.

Policy makers have clearly announced their intention to rein in the value of implicit guarantees

Against the background of the various observations regarding the economic costs arising from the persistence of implicit guarantees for bank debt and notwithstanding the potential complications arising from raising awareness of the issue, the need to address the issue has been reiterated in various recent policy reports. Numerous policy makers have clearly announced their intentions to limit the adverse feedback mechanisms that link banking sectors with their sovereigns and several policy initiatives and, in particular, they have explicitly stated that they want to rid banks of the benefits of such implicit guarantees:

“In short, the crisis exposed a range of problems which required action, most crucial of which is the perceived implicit guarantee enjoyed by banks and other financial firms.” (UK Treasury, 2012)

“The Government also strongly agrees with the PCBS [Parliamentary Commission on Banking Standards] that the overall objective of banking reform should be to curtail any perceived implicit guarantees enjoyed by banks seen as “too big to fail”, by helping to ensure that failing banks can be resolved without recourse to public funds: A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic....” (UK Treasury, 2013)

“The implicit subsidy causes different types of distortion: • Competitive distortions... • Excessive risk-taking... • Misallocation of resources to banking sector ... Reducing the implicit subsidy is therefore a key concern for policy makers. (“Liikanen report”, 2012)

The implicit government guarantee that arises when public authorities are perceived to have limited options in dealing with a threatened failure of a financial institution, leading them to bail it out and pass on the costs of failure to taxpayers, provides a public subsidy to TBTF [“Too-Big-To-Fail”] firms in the form of lower funding costs and adversely affects market discipline, competition, systemic risk and public finances. (first paragraph of concluding section

“Conclusion – overall progress to date and next steps” of FSB progress report on ending TBTF, 3 September 2013).

The issues of “too-big-to-fail” and “implicit guarantees for bank debt” are closely linked

Work by the CMF on developing such measures and on the issue of implicit bank debt guarantees more generally will inform ongoing work elsewhere on addressing the too-big-to-fail (TBTF) issue. That the two issues, that of implicit guarantees and the too-big-to-fail issue, are closely connected, is very succinctly described in a speech by a Member of the Executive Board of the Deutsche Bundesbank (Dombret, 2013):

While concepts have been developed to initiate regulatory reforms, it troubles me tremendously to have to state that the “too-big-to-fail” problem still remains unresolved. Market participants continue to anticipate that governments will rescue systemically important financial institutions – or SIFIs – in the event of their failure. The resulting refinancing advantage is reflected in so-called rating “uplifts”. Rating agencies usually calculate two different ratings for banks. One is a “stand-alone” rating that measures a bank’s genuine creditworthiness. The other is the “all-in” rating which includes the likelihood and extent of external support available for the bank’s debt. The difference between these two ratings is the “uplift”. It delivers a proxy for funding subsidies, which are benefiting SIFIs. Although these uplift factors have recently shrunk to some degree, they unfortunately remain substantial. This could be taken as an indicator supporting my claim that the “too-big-to-fail” problem remains unresolved.

Thus, progress made in reining in the value of implicit bank debt guarantees can be expected to reflect progress made in reducing the TBTF issue, at least to some extent. In this context, the FSB delivered, in September 2013, a progress report towards ending TBTF. That report did not include numerical estimates of the extent and value of implicit bank debt guarantees, although the FSB recognises that the issues of “too-big-to-fail” (or “too important for another reason to fail”) and the persistence of substantial values of implicit bank debt guarantees are closely linked.

The survey responses and CMF discussions in April 2014 are consistent with the view that the issues of TBTF and implicit guarantees are closely linked to each other. One respondent noted that even if the perception of an implicit government guarantee of bank debt generate costs by itself, the issue should be addressed in conjunction with that of TBTF rather than being considered a stand-alone issue. One could argue that the persistence of implicit guarantees is a symptom of the existence of the TBTF perception rather than a problem *per se*, even if the TBTF issue creates costs on its own.

Progress in reducing the value of implicit guarantees needs to be measured

CMF discussions and responses to the questionnaire suggest that the availability of robust measures of the value of implicit guarantees is a key input to i) monitoring efforts to rein in the value of implicit guarantees as well as to ii) assessing regulatory progress and, i.e. policy makers need to develop such measures to monitor how regulatory actions are reflected in the value of implicit guarantees. In particular, measuring the value of implicit guarantees should be a key input into the regulatory reform discussion, as it allows one to have an indication of the potential magnitude of the various types of distortions discussed above and to what extent progress is made in reducing them (see also Noss and Sowerbutts, 2012).

One of the key findings of the companion report on measurement and analysis of the value of implicit bank debt guarantees (Schich and Aydin, 2014) is, however, that currently there is a lack of widely agreed measures of the extent and value of implicit bank debt guarantees, even if the recently increasing number of academic and institutional studies on such measures suggests their growing availability.

III. Policies taken or considered with a potential bearing on the value of implicit guarantees

Part of the bank regulatory reform agenda is still work in progress in many jurisdictions

Many policy measures have already been taken and yet others are being considered and perhaps anticipated by market participants. The observed decline, even if only moderate, of measures of the value of implicit guarantees is consistent with the suggestion that the measures already taken or the anticipation of those planned or considered have been effective in reducing the value of implicit bank debt guarantees.

That said, it is acknowledged that the bank regulatory reform agendas to end too-big-to-fail are still work in progress in many jurisdictions. In fact, many details of the design of bank regulatory reform are still under consideration and various measures not yet fully rolled out, which explains in part the persistence of relatively high values of implicit guarantees on bank debt.

Policy measures taken or considered with a potential bearing on the value of implicit guarantees

While it is clear that in order to revive the functioning of market discipline the value of these debt guarantees must be further reined in, the real question remains how to do so and what additional specific measures to take? Previous discussions of the issue by the CMF did not reveal any clear consensus on how best to respond to this situation, although delegates agreed that they could usefully learn from one another what works and what does not in limiting the value of implicit guarantees. With this ultimate aim in mind, the survey included a stocktaking exercise in relation to policies taken or considered by its members with a potential bearing on this value.

Survey question

The survey asked pointedly what policies respondents have either implemented or considered that could be expected to have a bearing on the value of implicit bank debt guarantees (even if not primarily aimed at having this effect). It also asked whether the effect of the policy, once implemented, is considered by respondents to be significant in limiting the value of implicit guarantees.

To facilitate the responses the questionnaire listed a wide range of specific policy choices that the CMF considered to be representative of the spectrum of policy choices that can be expected to have an effect on the value of implicit bank debt guarantees.³ A list of altogether 33 specific policy choices was included in the final questionnaire, grouped under 12 policy headings, and respondents were offered the choice between i) “implemented”, ii) “currently planned for implementation/under consideration” and iii) “not considered helpful”. The list of specific policy choices included, together with the policy headings grouping them, are shown in Table 1. The questionnaire also invited respondents to assess the effect on the value of implicit bank debt guarantees of specific

policy measures once implemented, with respondents being offered the choice between i) “Don’t know”, ii) “Insignificant”, iii) “Significant (in desired direction)”.

Specific policy measures either widely implemented or being considered

Table 1 shows the specific policy measures considered and the colour-shading provides a broad indication of how relevant each measure is in practice; it refers to the sum of responses that either reported a measure as having already been implemented or currently considered for implementation.

More than 75% of respondents reported that they have either implemented or are considering implementation of the following specific policy choices (highlighted by dark blue-shading next to the specific measure listed in Table 1):

- implement internationally agreed capital and liquidity standards (Policy 1.1 and 2.1);
- top-up internationally agreed capital standards (Policy 1.2);
- enhance ongoing efforts to improve governance, risk management and disclosure by banks (Policy 3.1);
- tighten on-site and off-site bank supervision (Policy 4.1 and 4.2); and
- allocate more resources to supervision (Policy 4.3).

Similarly, more than 75% of the respondents reported that they either have implemented or are considering implementation of all of the specific policies listed under the broad heading “facilitate more effective resolution” (Policy category 7); these include:

- measures to establish new or make more effective existing bank failure resolution regimes (Policy 7.1),
- strengthen unsecured creditor bail-in mechanisms (Policy 7.2),
- require mandatory issuance of specific amounts of instruments, such as subordinated debt or debt to be converted into equity under specific circumstances (Policy 7.3),
- establish separate industry-financed funds for systemic crisis resolution (Policy 7.4), and
- require banks to develop plans as to how their operations could be dismantled (Policy 8.4). The latter measure can be expected to facilitate more effective resolution.⁴

Finally, other measures that are similarly highly ranked by questionnaire respondents according to the above criterion (*i.e.* being implemented or considered by more than 75% of the respondents) include those to:

- impose other costs on banks such as extra capital charges that rise with measures of “systemic importance” of the bank (Policy 12.1),
- strengthen deposit insurance arrangements and their funding (Policy 9.1), and
- introduce insured depositor preference (Policy 9.3). Incidentally, implementing depositor preference – as opposed to insured deposit preference – received a marginally lower positive response rate of just below 75% of the respondents.

An additional observation is that response rates were comparatively higher for specific policy choices that are being negotiated and agreed upon at the international level, such as those to improve capital and liquidity standards, implement or refine bank failure resolution mechanisms, strengthen deposit insurance funding, etc.⁵

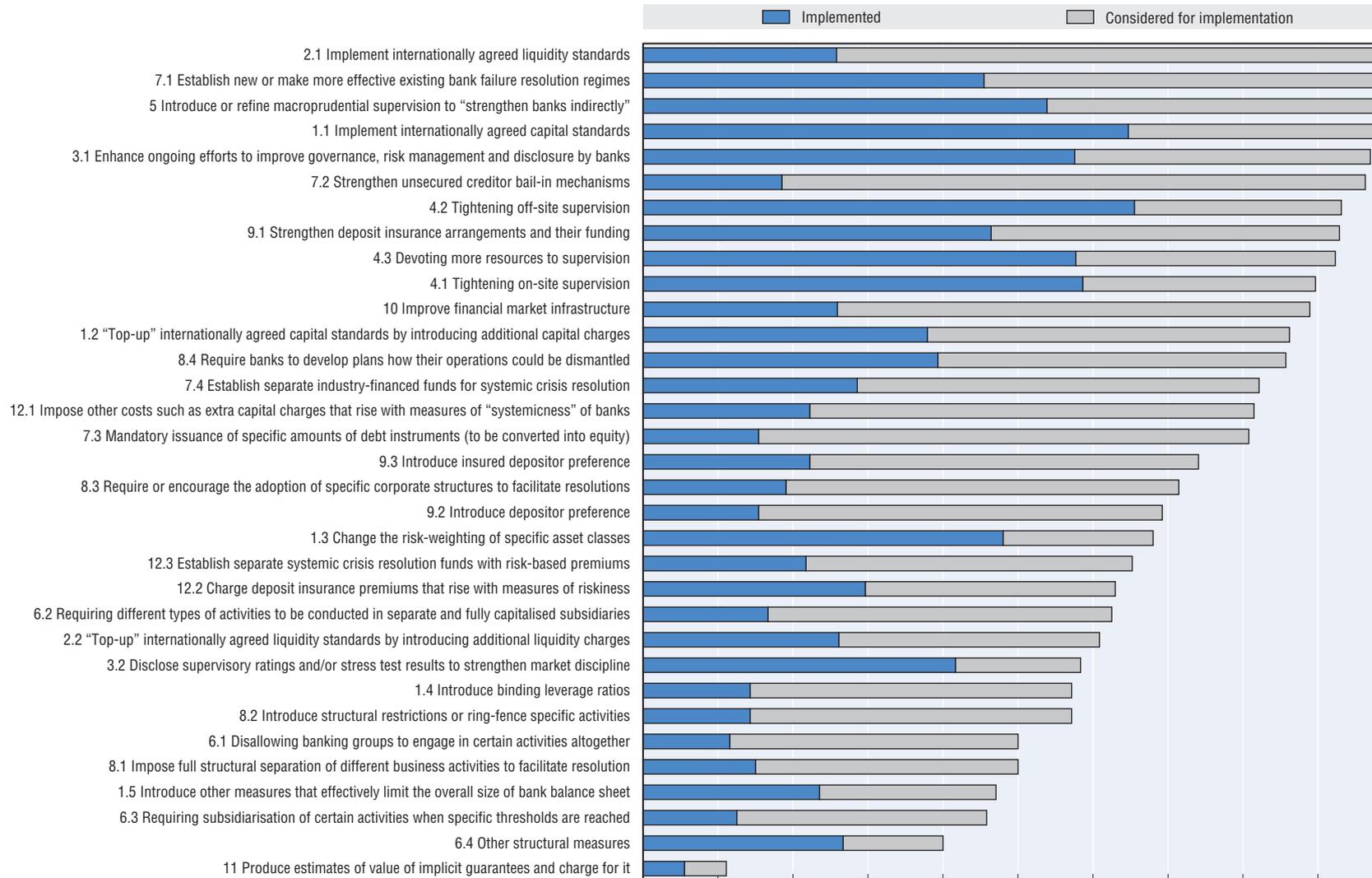
While Table 1 identifies policies widely implemented or being considered by colour-shading, Figure 1 uses the information to *rank* all specific policy options by the sum of

Table 1. Policies either implemented or being considered for implementation

Strengthen Banks (Reduce the likelihood of bank default):	
Policy 1	Enhance the quantity and quality of capital at the level of the bank
1.1	Implement internationally agreed capital standards
1.2	“Top-up” internationally agreed capital standards by introducing additional capital charges
1.3	Change the risk-weighting of specific asset classes
1.4	Introduce binding leverage ratios
1.5	Introduce other measures that effectively limit the overall size of bank balance sheet
Policy 2	Enhance the quantity and quality of liquidity at the level of the bank
2.1	Implement internationally agreed liquidity standards
2.2	“Top-up” internationally agreed liquidity standards by introducing additional liquidity charges
Policy 3	Improve governance, risk management and disclosure of banks
3.1	Enhance ongoing efforts to improve governance, risk management and disclosure by banks
3.2	Disclose supervisory ratings and/or stress test results to strengthen market discipline
Policy 4	Tighten microprudential supervision to strengthen banks directly
4.1	Tightening on-site supervision
4.2	Tightening off-site supervision
4.3	Devoting more resources to supervision
Policy 5	Introduce or refine macroprudential supervision to “strengthen banks indirectly”
Policy 6	Introduce structural restrictions to avoid undesired cross-subsidisation between parts of banking groups
6.1	Disallowing banking groups to engage in certain activities altogether
6.2	Requiring different types of activities to be conducted in separate and fully capitalised subsidiaries
6.3	Requiring subsidiarisation of certain activities when specific thresholds of the extent of such activities are reached
6.4	Other structural measures
Strengthen the Capacity to Withdraw Guarantees:	
Policy 7	Facilitate more effective resolution
7.1	Establish new or make more effective existing bank failure resolution regimes
7.2	Strengthen unsecured creditor bail-in mechanisms
7.3	Mandatory issuance of specific amounts of instruments (e.g. subordinated debt or debt to be converted into equity under specific circumstances)
7.4	Establish separate industry-financed funds for systemic crisis resolution to have funds available when required
Policy 8	Introduce structural restrictions to limit failure resolution costs and better protect claims considered worth protecting
8.1	Impose full structural separation of different business activities to facilitate resolution
8.2	Introduce structural restrictions or ring-fence specific activities
8.3	Require or encourage the adoption of specific corporate structures to facilitate resolutions
8.4	Require banks to develop plans how their operations could be dismantled
Policy 9	Strengthen deposit insurance directly
9.1	Strengthen deposit insurance arrangements and their funding
9.2	Introduce depositor preference
9.3	Introduce insured depositor preference
Policy 10	Improve financial market infrastructure
Charge a user fee to incentivise banks to reduce their “use” of implicit guarantees:	
Policy 11	Directly: produce estimates of the value of implicit guarantees and charge banks for it (thus making them explicit)
Policy 12	Indirectly: Impose other costs thus incentivising banks to make less “use” of guarantee
12.1	Impose other costs such as extra capital charges that rise with measures of “systemicness” of banks
12.2	Charge deposit insurance premiums that rise with measures of riskiness
12.3	Establish separate systemic crisis resolution funds with risk-based premiums

Note: The colour-shading relates to the sum of respondents (in percentages) either i) having implemented or ii) considered implementation of the specific policy, with the alternative answer allowed to that question being “not considered helpful”. Dark blue-shading indicates policies implemented or considered by at least 75% of respondents. Light blue-shading refer to policies either implemented or currently being considered or planned to be implemented by 50% to 75% of respondents. Grey-shading refers to policies considered or planned to be implemented by less than 50% of respondents. The percentages shown for broad policy categories (e.g. Policy 1) are obtained as the unweighted average of all responses to the specific policy choices in that category.

Figure 1. Specific policies implemented or considered for implementation



Note: The length of the bars represents the sum of respondents either having implemented (in dark blue-shading) or are currently considering implementation (in grey-shading) the specific policy, expressed in percentages of responses to the question regarding implementation (note that the alternative answer allowed is “not considered helpful”). For example, all respondents have either already implemented or are considering implementation of internationally agreed liquidity standards, with about 25 per cent of respondents having already implemented such measures (dark blue-shading).

respondents that reported either having already implemented or actively considering implementation of the respective policy. In addition, Figure 1 identifies separately the percentages of respondents having already implemented that policy. As regards the latter, the policies that have already been implemented by the highest percentage of respondents (as indicated by the dark-blue shading of the bars) are those to:

- implement internationally agreed capital standards (Policy 1.1) and
- tighten both on site and off site supervision (Policy 4.1 and 4.2).

Broad categories describing the policies widely implemented or being considered

Figure 2 shows the sums of responses given under each broad heading (referring to categories of specific policies and again expressed as percentage shares of total responses) of the responses given to the specific policy choices. In terms of these broad policy categories, the policies that have already been most widely implemented fall into the following categories:

- to strengthen banks through tighter supervision – both in micro and macro prudential terms (Policy category 4 and 5) and
- to implement measures to improve governance, risk management and disclosure of banks (Policy category 3).

Specific policy measures or broad categories not yet adopted but currently under consideration

Among measures not yet adopted (Figure 1), the three specific policies that are currently most widely considered for implementation are

- measures to strengthen unsecured creditor bail-in mechanisms (Policy 7.2),
- implement internationally agreed liquidity standards (Policy 2.1), and
- mandatory issuance of specific amounts of instruments such as subordinated debt or debt to be converted into equity under specific circumstances (Policy 7.3).

Turning again to the *broad* categories (headings), the measures not yet adopted but planned to be implemented or currently being considered by the largest majority of respondents are (Figure 2):

- to improve financial market infrastructure (Policy category 10),
- to facilitate more effective resolution (Policy category 7) and
- to enhance the quantity and quality of liquidity at the level of the bank (Policy category 2).

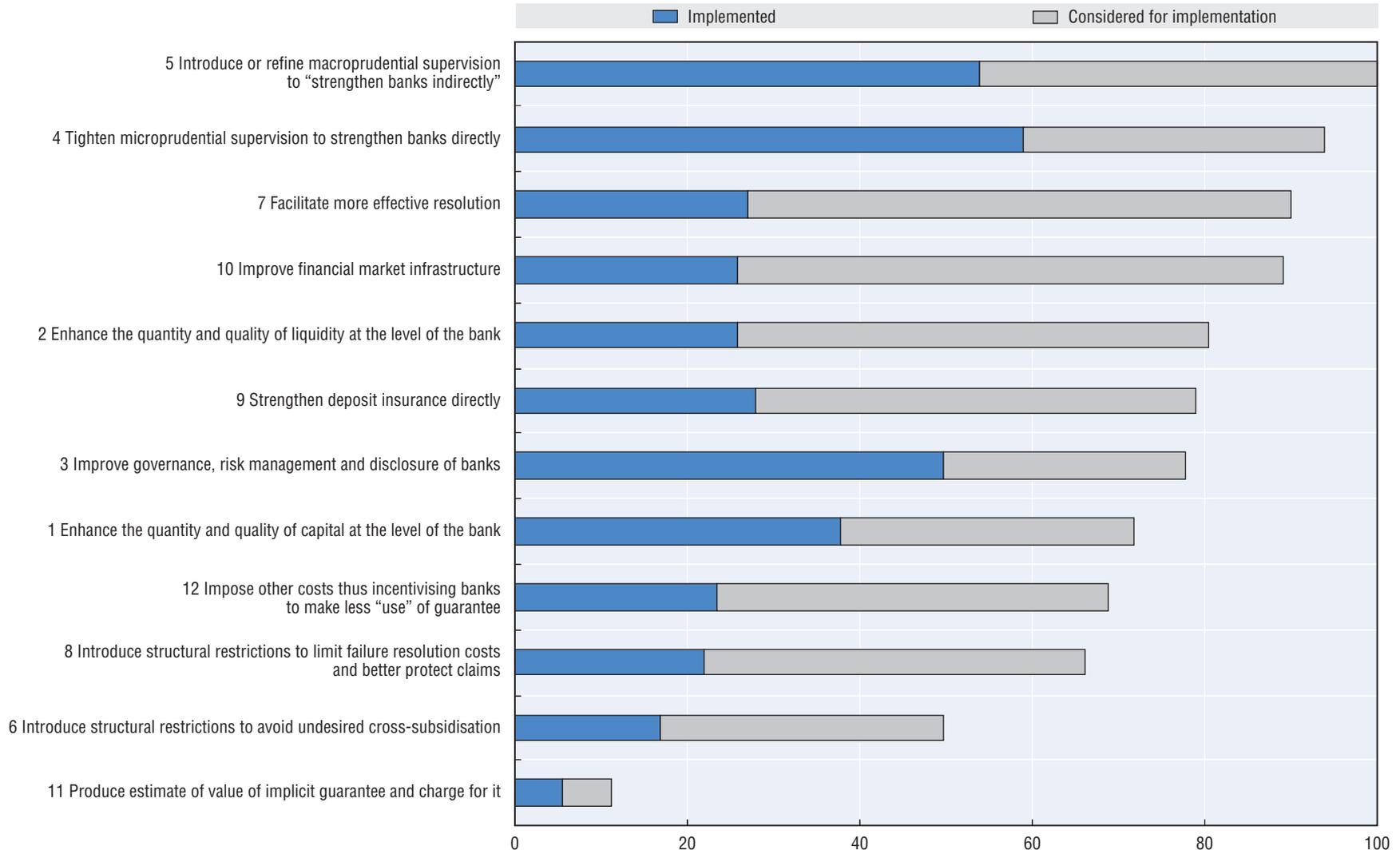
Policies most often mentioned

The mix of different policy measures implemented or being considered for implementation differs from one respondent to another, but there are some policies that stand out. A summary of the three policies most often mentioned under the different headings (i.e. specific policies or broad categories; already implemented or implementation being considered) is provided in Table 2.

Assessment of potential significance of effects of policy choices on the value of guarantees

Finally, the questionnaire also asked respondents to assess the effect on the value of implicit bank debt guarantees of specific policy measures if they are already implemented

Figure 2. Categories of policies implemented or considered



Note: The length of the bars represents the sum of respondents either having implemented (in dark blue-shading) or are currently considering implementation (in grey-shading) the specific policy, expressed in percentages of responses to the question regarding implementation (note that the alternative answer allowed is “not considered helpful”). For example, all respondents have either already implemented or are considering implementation of measures to introduce or refine macroprudential supervision to “strengthen banks indirectly”, with slightly more than 50 per cent of respondents having already implemented such measures (dark blue-shading).

Table 2. **Categories of policies implemented or considered for implementation**

	Measures implemented	Measures under consideration
Top-3 specific policies	Implement internationally agreed capital standards	Strengthen unsecured creditor bail-in mechanisms
	Tighten on-site supervision	Implement internationally agreed liquidity standards
	Tighten off-site supervision	Mandatory issuance of specific amounts of instruments such as subordinated or convertible debt
Top-3 broad policy categories	Strengthen banks through tighter supervision at micro level	Improve financial market infrastructure
	Strengthen banks through tighter supervision at macro-prudential level	Facilitate more effective resolution
	Improve governance, risk management and disclosure of banks	Enhance quantity and quality of liquidity at bank level of banks

Note: Policy measures cited most widely by respondents as implemented or considered for implementation with a potential bearing on the value of implicit guarantees.

(or once they are implemented). The responses show that a large number of specific policies are expected by a majority of respondents to have a significant (i.e. limiting) effect on the value of implicit bank debt guarantees. Figure 3 highlights these specific policies by dark-blue-shaded bars.⁶ They include the following:

- Implement internationally agreed capital and liquidity standards (Policies 1.1 and 2.1);
- Introduce or refine macroprudential supervision to “strengthen banks indirectly” (Policy 5);
- Establish new or make more effective existing bank failure resolution regimes (Policy 7.1).

By contrast, a few measures are not considered to have such an effect by a majority of respondents; in these cases a majority of respondents reported that they do not know whether the effect would be significant. These are highlighted in Figure 3 by grey-shaded bars. Among these measures, the charging of direct user fees (Policy 11) is considered, for example, to be significant by only a small percentage of respondents.

Incidentally, the length of the bars indicates the sum of responses (expressed in percentage shares of all responses) either having implemented or considering implementation of the respective policy when asked regarding implementation or consideration of that specific policy; almost all respondents reported that they consider Policy 11 as “not helpful” in that context.

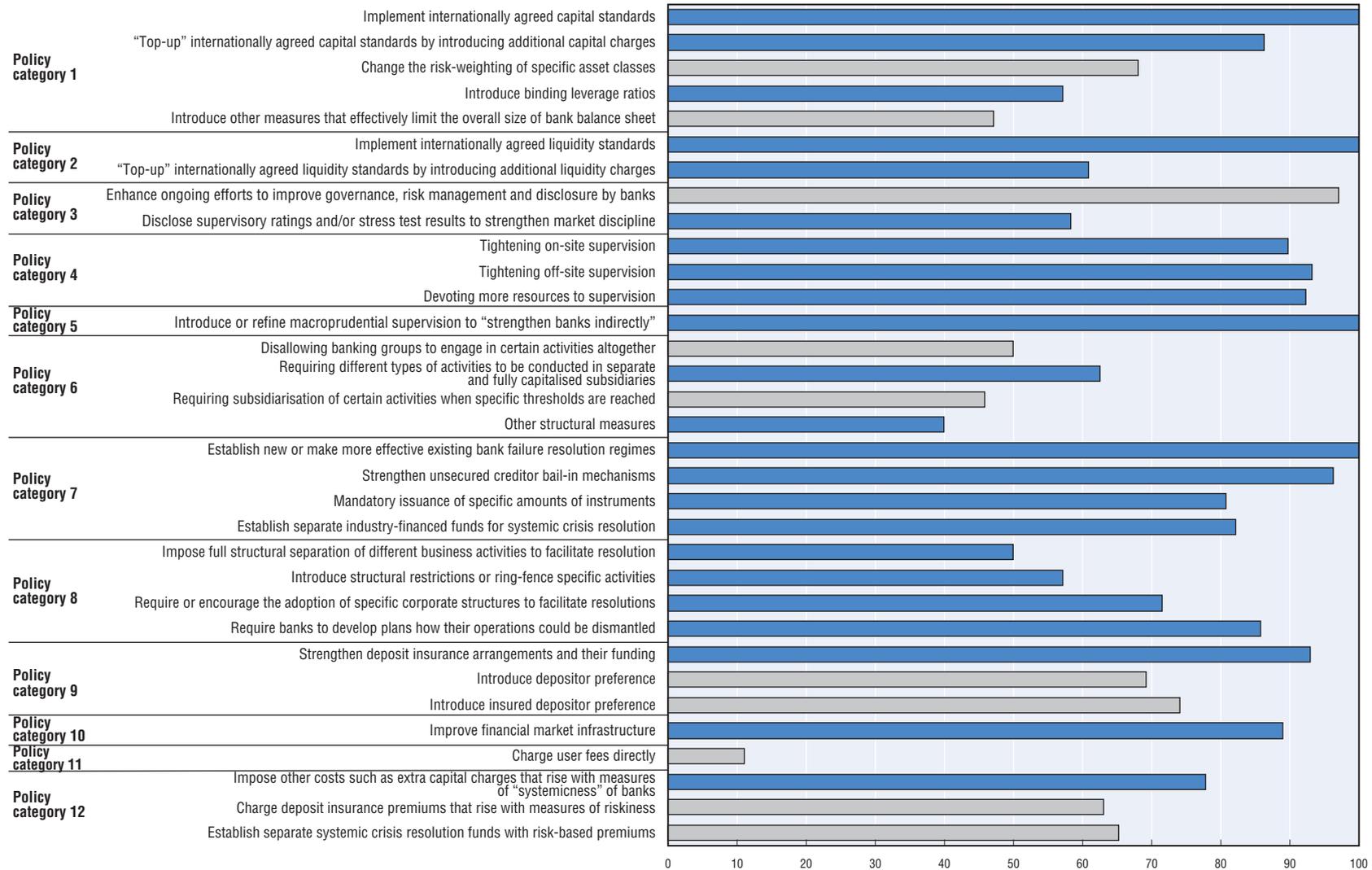
IV. Questionnaire feedback on selected specific areas of reform

Making banks more resolvable

Respondents to the CMF questionnaire noted that bank failure resolution regimes have been changed or are currently being changed to achieve more effective bank failure resolution and in particular to facilitate the involvement of unsecured creditors in the related burden sharing. The responses overall reveal a considerable conviction that progress in this area is important and this observation is consistent with current international efforts within the Financial Stability Board (FSB), which among other things has established the Key Attributes of Effective Resolution Regimes for Financial Institutions as a new international standard.

In the European Union an agreement was reached between the European Parliament and EU Member States on the Bank Recovery and Resolution Directive (BRRD), considered a fundamental element of the framework for the European Banking Union. The BRRD, which will enter into force on 1 January 2015, establishes a comprehensive and credible

Figure 3. How do you assess the effect on the value of implicit bank debt guarantees if the specific policy has been implemented or the potential effect if it is currently considered for implementation?



Note: The length of the bars represents the sum of respondents having either i) implemented or ii) are considering implementation of the specific policy, expressed as percentage of total responses to the question regarding implementation (alternative answer allowed is "not considered helpful"). The lengths of the bars can be interpreted as a broad indication of the relevance of that specific policy measure according to survey respondents. The colour-shading refers to the assessment by respondents of the possible significance of the measure under consideration, about which respondents were asked in a follow-up question. Blue-shading indicates that at least 50 per cent of respondents to that question consider that the effect of the policy measure would have a significant effect on the value of implicit bank debt guarantees, limiting it. Grey-shading indicates that more than 50 per cent of respondents either answered "Don't know" or "Insignificant", the two alternatives to "Significant".

resolution framework and foresees that the bail-in tool will apply in two stages: The first stage comprises the application of state aid rules in the 2014-15 period and the second stage corresponds to the full application of creditor bail-in rules starting from 1 January 2016.

In April 2014, the BRRD and the regulation establishing the Single Resolution Mechanism (SRM) was adopted by the European Parliament. The SRM is a system involving the European Central Bank, European Commission, a new Single Resolution Board (SRB), and national authorities for deciding on the timing and details of bank recovery and resolution. The SRM will apply the rules from the BRRD in all countries to which the Single Supervisory Mechanism (SSM) applies, that is in all euro area countries. The SRM will be backed by a Single Resolution Fund that ultimately will be pooled across all the countries participating in the SSM. Among other things, this arrangement is expected to help limit or break the adverse feedback link observed between (weak) banks and sovereigns and facilitate effective bank failure resolution.

Respondents to the OECD/CMF survey agree on the importance of bail-in as a leading principle of bank recovery and resolution. More than 75% of respondents noted that they have either implemented or are considering for implementation the four specific policy choices offered under the header “facilitate more effective resolution” (Policy category 7 in Table 1), which include establishing new or making more effective existing bank failure resolution regimes, strengthening unsecured creditor bail-in mechanisms, requiring mandatory issuance of specific amounts of instruments such as subordinated debt or debt to be converted into equity under specific circumstances, and establishing separate industry-financed funds for systemic crisis resolution to have funds available when required. Also, more than 75% of respondents have implemented or are considering “requiring banks to develop plans how their operations could be dismantled” (Policy 8.4 in Table 1).

It was noted however that the effectiveness of the bail-in principle and other resolution measures hinges on the effectiveness of cross-border cooperation and the recognition of foreign resolution regimes across jurisdictions. Given the high level of interconnection of banking sectors across countries, a key outstanding issue remains however the effectiveness of cross-border cooperation in resolution and recognition of foreign resolution measures at the world-wide level.

There seems to be agreement among survey respondents that the value of implicit guarantees reflects to a large extent the smooth functioning of exit mechanisms for failing banks, also as the conditions of a potential exit determine current pricing of bank debt and hence bank risk-taking. Having available smooth and effectively operating bank failure resolution regimes implies that the value of implicit guarantees is reduced, as, in effect, the capacity (and perhaps also willingness) of policy makers to withdraw the guarantee function is strengthened. Under those circumstances, banks would be less likely to take excessive risks, which in turn would lower the value of implicit bank debt guarantees.

Recent progress on the BRRD seems to have had some effect on the value of implicit guarantees on bank debt. For example, the rating agency Moody's, in assessing the EU BRRD, sees it as “credit-negative” for the senior unsecured creditors of the two-thirds of the European banks, the ratings of which do incorporate some level of systemic support uplift. That said, Moody's states that it is unlikely to remove all systemic support assumptions from the rating of every EU bank in the foreseeable future for now (Moody's, 2013), arguing that the full extent of bank regulatory reform measures including those related to structural restrictions is not yet known.

Restricting bank business lines

As regards the issue of imposing additional structural restrictions on bank business activities, in response to the global financial crisis, several new proposals have been adopted or made. They include but are not restricted to the so-called Volcker rule, the Vickers rule, the Liikanen proposal, the OECD Secretariat's non-operating holding company proposal, etc. Several of these approaches are reviewed and compared to the proposal supported by the OECD Secretariat in Blundell-Wignall and Atkinson (2012) and Blundell-Wignall, Atkinson, and Roulet (2014).

Many of these approaches focus on the structural separation of different types of businesses, typically retail or traditional commercial banking versus investment banking or the trading of securities or derivatives. All approaches have in common that they constrain the allowed activities of banks. They differ nonetheless regarding the question of where the lines for separation should be drawn, as well as to what extent the main focus of the separation is to disallow certain types of activities or to protect specific claims.

Such restrictions are not new. Perhaps the best known historical example is embodied in the Glass-Steagall Act from 1933 (and the Bank Holding Company Act of 1956) from the United States, disallowing traditional commercial banks to undertake securities activities or insurance. Many of the specific prohibitions were eroded over time by financial innovations and, in 1999, the Gramm-Leach-Bliley Act undid those prohibitions.⁷

The decision to revoke the Glass-Steagall prohibitions was exemplary of the mood in regulatory circles at that time, which believed that restrictions on the lines of bank businesses would tend to prevent the real economy from reaping the full benefits of financial sector development. The view was based on the assumption that diversification, advances in risk management and market-based pricing, and market disciplining would limit risk-taking and financial stability risks.

That view overestimated however the effectiveness of market discipline and underestimated, among other things, the incidence and distortive effects of implicit guarantees. Risk-taking was encouraged, as well as market discipline undermined, by the expected availability of underpriced access to the financial safety net of large parts of the financial sector. Over time, the operation of the financial safety net has probably tilted the balance between the effects of upside and downside financial market episodes in the sense that profits in good times are privatised while losses in bad times are, at least partly, socialised. As a result, the episodes of financial market stress do not serve as a means to clear out the underbrush of overcapacity and excessive resource allocation in the banking sector.

Entities conducting both commercial and investment banking activities under one roof and backed by one capital base were among the diverse types of entities at the core of the global financial crisis, even if they were not alone in that regard. In fact, one of the key findings of the Liikanen (2012) report is that no specific type of business model fared better than others. Be that as it may, it is increasingly being appreciated that cross-subsidisation from the commercial banking to the investment banking side in such entities played a role in the build-up of risks prior to the crisis, ultimately threatening the safety of those claims on the commercial banking side that the financial safety net initially was set up to protect.

Thus, in response to the crisis, the economic costs and benefits of allowing banks relatively unrestricted activities are being reassessed. Reform proposals have proliferated and added to an existing set of approaches spanning the spectrum from requiring entities

with access to the safety net to conduct only so-called narrow banking to disallowing financial groups to engage in certain specific activities once the relative importance of such activities reaches a specific threshold. The narrow banking proposal essentially foresees limiting the activities of deposit-taking banks to the provision of payment services and investments in safe and liquid assets (although some variations of such proposals would also allow lending to small or medium-sized firms). Such an approach would make deposit insurance effectively unnecessary, as all these banks' assets would be marked to market daily and cover the value of deposits withdrawable on demand (Todd, 2009). The idea of making retail banks resemble a regulated public utility company had been reintroduced into the debate of bank regulatory reform in 1987 by Litan, who proposed authorising "financial holding companies" the subsidiaries of which would separately conduct different types of financial services and be adequately capitalised. The proposal has been met with the criticism that the separation of different services would generate inefficiencies.

The costs and benefits of imposing some forms of separation, that is of imposing tighter structural restrictions on the allowed business activities of banks, are analysed in European Commission (2014), as part of its impact assessment in relation to a regulation on structural measures for improving the resilience of EU credit institutions, following up on Liikanen (2012). Also, the FSB is undertaking a stocktaking exercise of national jurisdictions' planned or implemented structural banking reforms, as well as observed or expected effects in other jurisdictions' domestic markets of such reforms. This work is pursuant to a call in 2013 from the G20 on the FSB, in collaboration with the IMF and the OECD, to assess cross-border consistencies and global financial stability implications of structural banking reforms, taking into account country-specific circumstances, and to report to the 2014 Leaders' Summit.

While a consensus on structural restrictions has yet to be reached, the evidence identified so far has been sufficient that variations of such approaches have been adopted or proposed in several jurisdictions in order to complement efforts to improve resolution regimes, supervision and capital and liquidity buffers. In fact, there seems to be an appreciation of the need for additional measures to those relied on in recent decades to supplement the functioning of market discipline to limit risk-taking. There is growing evidence that these additional measures may include imposing more stringent structural restrictions on bank business lines.

The responses to the CMF questionnaire on implicit bank debt guarantees provides only limited support for this approach, however. The questionnaire spelled out various policy choices that introduce structural restrictions to avoid undesired cross-subsidisation between parts of banking groups (Policy category 6 in Table 1). This question received a fairly high response rate, although more than 50% considered three of the four policy choices offered under this heading as "not helpful". These three policy choices include "disallowing banking groups to engage in certain activities altogether" (Policy 6.1), "requiring subsidiarisation of certain activities when specific thresholds of the extent of such activities are reached" (Policy 6.3), and "other structural measures" (Policy 6.4). Such a high ratio of negative responses is unusual compared to other policy choices given.⁸

One specific policy choice within Policy category 6, i.e. requiring different types of activities to be conducted in separate and fully capitalised subsidiaries (Policy 6.2), met however with less scepticism. That policy was already implemented by 17% and is

currently being considered by about 46% of respondents, with only 38% of respondents considering that policy as “unhelpful”. As regards expected significance of that policy, once implemented, about 63% of responses considered that Policy 6.2 would have a significant effect on the value of implicit bank debt guarantees, although that percentage refers to a small number of responses (just 8 responses).

Making implicit guarantees explicit

Implicit guarantees are fiscal risks that, even if they might not always eventually result in actual or contingent fiscal liabilities, are nonetheless potentially significant for government budgets. As the fiscal risks stem from implicit rather than explicit government guarantees, the implicit contingent liabilities are typically not reflected in budgets, not fully and transparently disclosed and hence not subject to the same public scrutiny as some other contingent liabilities. This observation raises concerns (see e.g. Box 1).

Box 1. Recognising implicit liabilities as contingent fiscal liabilities

The OECD’s Working Party of Senior Budget Officials, at its 34th annual meeting in 2013, discussed the issue of contingent fiscal liabilities on the basis of a background paper “Budgeting for Contingent Liabilities – Discussion Paper” (OECD, 2013). The paper defines contingent liabilities as “fiscal risks that are often hidden and potentially significant and the implications of which are often poorly apprehended by governments and their citizens.” It analyses the economic problems arising from contingent liabilities, with a special focus on the fiscal dimension, and suggest measures that can mitigate the identified problems.

The paper observes that the financial sector is the single largest source of contingent fiscal liabilities, although this assessment seems to refer mainly to the period following the beginning of the global financial crisis and the explicit guarantees given to the debt of financial institutions in this context. The observation appears to be based on estimates of explicit but not implicit guarantees, although the paper observes that contingent liabilities can be explicit or implicit: “Explicit contingent liabilities are those based on a contract and (except for probability) are like conventional debt. Implicit contingent liabilities are political or moral obligations. Implicit liabilities are often hidden: not disclosed nor measured. Governments can ‘convert’ implicit contingent liabilities to explicit liabilities.”

The paper argues that, as well as being a hidden form of sovereign debt, contingent liabilities are problematic because they are not treated neutrally with respect to other ways in which the government can finance its activities, with the true costs being underestimated. In resolving the resulting problems, the paper emphasises the benefits of transparency and suggest that, where practicable, “implicit contingent liabilities to be converted to explicit contingent liabilities except where the government can credibly (and sensibly) pre-commit to not honouring an implicit liability (in which case it would no longer be a contingent liability). Implicit contingent liabilities are difficult to understand, often unbounded and difficult to measure. They cannot be disclosed since the very disclosure creates an expectation. By making explicit a contingent liability, the cost can be constrained and expectations managed.”

Transparency is crucial for policy makers to be able to make sound decisions and to ensure that they can be held accountable. By making implicit guarantees explicit, additional ways of managing them become available. For example, market forces could be usefully employed to reduce the value of implicit bank debt guarantees, e.g. by setting aside the implied funding cost advantages and making them available to creditors or the deposit insurer in case of bank failure or by rewarding banks for efforts that make the value of implicit bank debt guarantees decline.⁹

But should governments really go that route and estimate the value of implicit guarantees and make these estimates public? Earlier discussions of that question by the CMF tended to conclude no. The question whether measures to make implicit guarantees explicit were implemented or being considered among CMF participants was again squarely raised in the CMF questionnaire on implicit bank debt guarantees, as part of a question on the various specific policy choices being implemented or considered by respondents (Policy 11 in Table 1).

The responses to that question were relatively less numerous than to many of the other policy choices given. In fact, only 19 responses were received with respect to that specific policy choice, while more than 30 responses were received with respect to several other policy choices. Perhaps even more notable, around 90% of those responding reported they did not consider that policy option as helpful. No other question received a similarly negative feedback in percentage terms.

Thus, there is little support among respondents to the OECD/CMF questionnaire on implicit bank debt guarantees for making the implicit guarantees explicit. In discussing the issue, some delegates suggested that such an approach would make more explicit what currently is at most implicit and it might thus undermine active efforts by policy makers to dispel the notion that such guarantees exist.

V. Assessing the overall thrust of policy measures with a bearing on the value of implicit guarantees

Describing the overall thrust of policy measures

In describing the overall thrust of the mix of specific policy measures, conceptually, three different options for policy makers are distinguished here that could be expected to limit the value of implicit bank debt guarantees (Schich, 2013a):

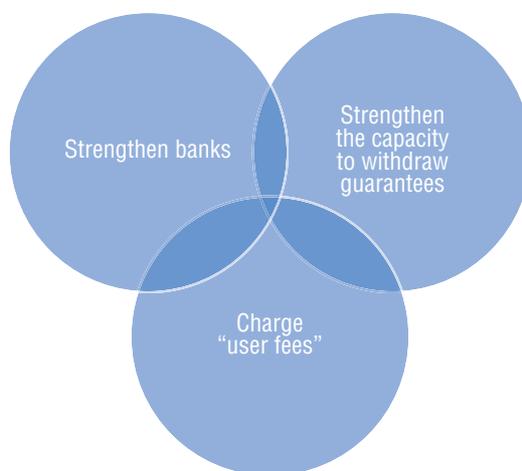
- “Strengthening banks”: The value of any debt guarantee is lower, the stronger is the debtor on a stand-alone basis (where the strength of the bank is defined in relative terms and, in particular, in relation to the challenges arising from its financial, business and economic environment).
- “Strengthening the (perceived) capacity or willingness to withdraw the guarantee function”: Making banks easier to resolve implies that the guarantee function would have to be invoked less frequently, thus reducing the value of that function.
- “Charging a direct or indirect user fee for the provision of the guarantee function”: Such measures would effectively price the implicit guarantee, thus providing banks with an incentive to make ‘less use’ of the guarantee function, again lowering the value of its availability.

A stylised view is provided in Figure 4, highlighting that policy choices could fall in either one or more of the three categories as defined above. In fact, the chart shows that there are areas of overlap between the three different stylised categories of policy choices.

Not all policy measures can be clearly assigned to a single one of the three categories. For example, the suggestion to tighten the restrictions on the range of the type of activities that a single financial group could conduct under one roof, as reflected in rules or proposals for “separation” (e.g. of certain traditional commercial from investment banking or securities activities) or “ring-fencing” (e.g. of retail deposit-taking from securities business), can be seen to achieve at least two of the abovementioned purposes. For one, “separation” tends to reduce the scope for cross-subsidisation, thus it could be expected that risks are better internalised and fewer risks taken. But “separation” can also be expected to facilitate the resolution of failed institutions, and the availability of smoother resolution tools strengthens the capacity of public authorities to withdraw the guarantee function altogether. The CMF questionnaire has reflected this overlap by considering similar policy choices under several different headings, but with somewhat nuanced motivations for the choice of action provided.

One of the key findings from the questionnaire responses, as explained in sections III and IV, is that no single policy measure alone can be considered to be the “silver bullet” capable on its own of eliminating the value of implicit bank debt guarantees. The various policies are seen as complementary. Figure 4 highlights that the three groups of policy choices are not alternatives but that they could complement one another. For example, while measures to strengthen the governments’ capacity to withdraw implicit guarantees are relevant and necessary, to be credible they also require measures to strengthen banks.

Figure 4. **Categories of policy choices with a potential bearing on the value of implicit guarantees**

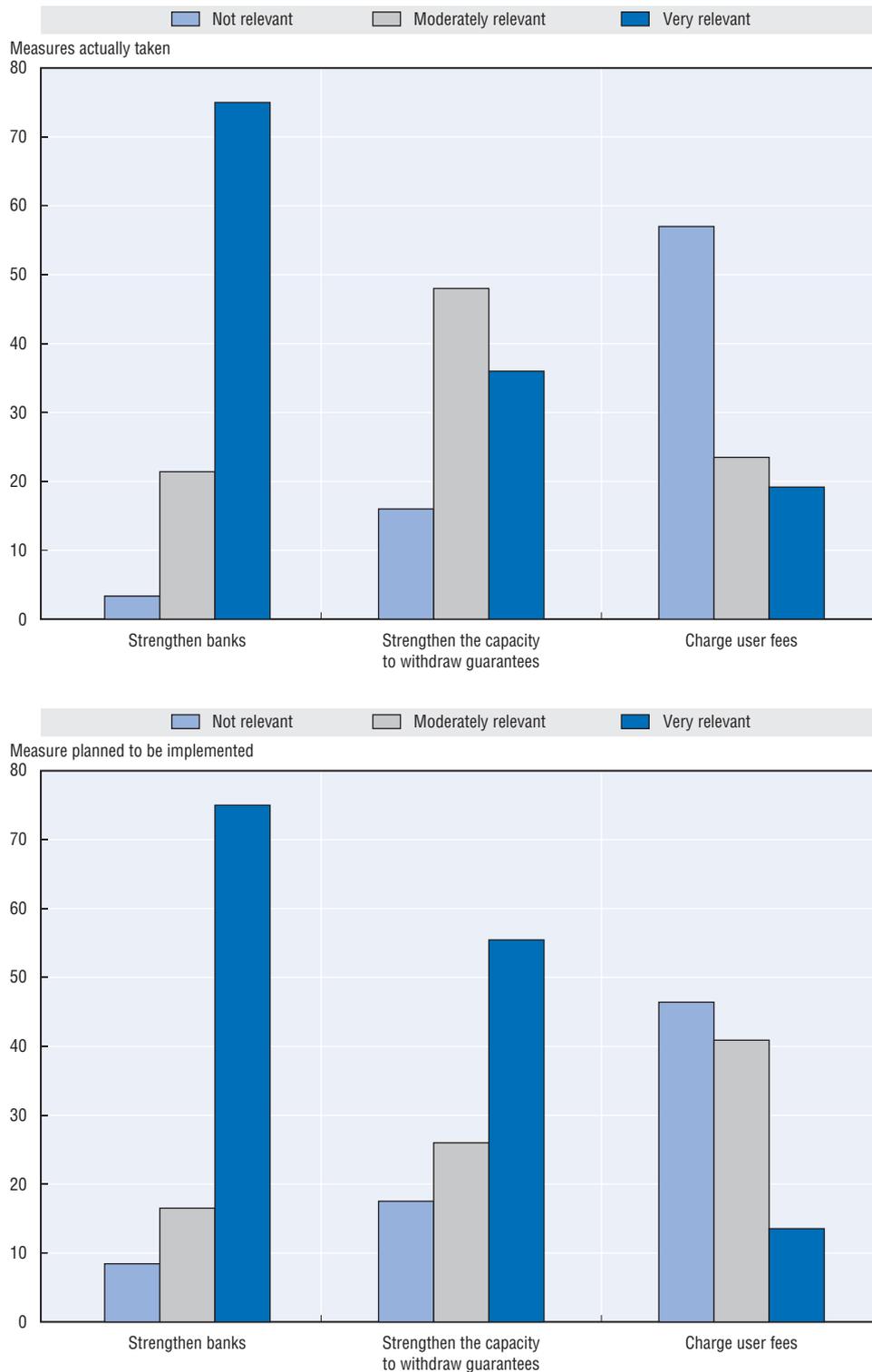


Note: Stylised representation of the potential mix of the thrust of policy responses to the issue of implicit bank debt guarantees.

The balance of the thrust of different policy measures implemented, considered or planned

Taking these dimensions as a base, the respondents were asked to describe the overall thrust of the mix of policy measures actually implemented or being considered since the pre-crisis period, taking into account all policy measures with a potential bearing on the value of implicit bank debt guarantees. The overwhelming majority of respondents considered “strengthening banks” as a relevant description of the overall thrust of policy measures (Figure 5). By contrast, “charging of a user fee” for the guarantee function, so as

Figure 5. **How would you describe the overall thrust of the mix of policy measures taken or considered with a potential bearing on the value of implicit bank debt guarantees?**



Note: Percentage of responses to the CMF questionnaire on implicit guarantees for bank debt.

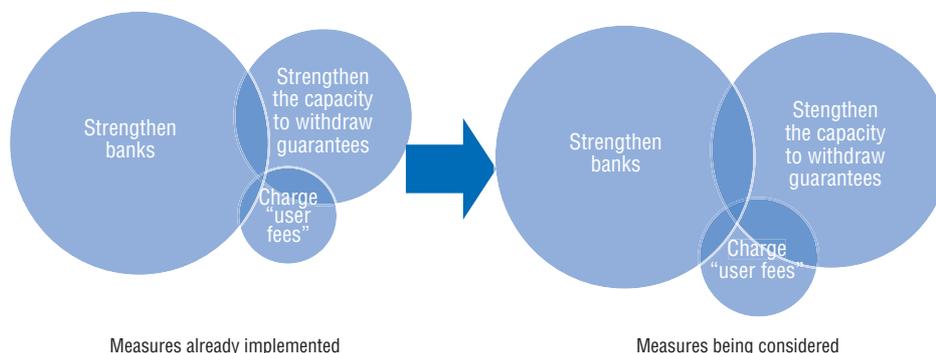
to incentivise banks to reduce their “use” of that function, was not considered a relevant description. “Strengthening the capacity to withdraw the guarantee function” took a middle position between these two.

Distinguishing between measures already taken on the one hand and those planned or currently being considered on the other revealed interesting nuances. As regards measures actually taken, about 48% of respondents considered “strengthening the capacity to withdraw the guarantee function” as a moderately relevant description of the measures. As regards measures planned or being considered, however, around 60% of responses considered that description very relevant. Thus, a shift in the overall thrust of the focus of policy actions seems to be taking place, moving from efforts to strengthen banks towards efforts to strengthen the capacity of policy makers to withdraw the (perceived) guarantee function from banks. This resulting shift in the mix of policy responses is illustrated in Figure 6, where each circle size reflects the percentage of respondents that report that they plan to implement respective policies and consider the relevant broad policy option as either moderately or very relevant.

Only a few respondents considered “charging a user fee” for the guarantee – either directly or indirectly and either explicitly or implicitly – a relevant description of the overall thrust of policy measures taken or considered in their jurisdictions. Such a course of policy action would have the effect of making explicit what is so far only implicit, which might have undesirable consequences.

In this context, one response to the OECD/CMF survey noted that imposing other costs such as extra capital charges that rise with measures of ‘systemic importance’ of banks should not be considered an implicit “user fee”, as no fee is *de facto* collected by anyone. Another respondent noted however that the acknowledgement by policy makers that creditors should bear losses – either by means of a burden shifting from the public to private resources or by means of bail-in debt instruments of senior unsecured creditors – and the establishment of private resolution funds essentially imply that some sort of “user fee” is actually being charged. All said, the responses revealed that respondents felt uneasy with regard to the suggestion to label certain policy measures as “effectively charging a user fee” for the provision of the implicit guarantee.

Figure 6. **Overall thrust of the mix of policy measures implemented and being considered**



Note: Respondents were asked to describe the overall thrust of the mix of policy measures that they have either implemented (“measures taken”) or are currently considering for implementation (“Measures being considered”). The size of each circle is a summary measure of the responses, with each response stating the relevant type of policy measure is “very relevant” being given a weight of 5, “moderately relevant” a weight of 3, and “not relevant” a weight of zero, respectively.

VI. Concluding remarks

Implicit guarantees for bank debt create significant economic costs and this observation is now increasingly being appreciated both by policy makers and the general public alike. Among other things, they weaken the functioning of market discipline to limit risk-taking. Against this background, policy makers have decided to rein in the value of such guarantees and have publicly announced their intentions to do so, with several recent announcements squarely linking the ongoing bank regulatory reform and in particular the bank failure resolution agenda to the issue.

The CMF questionnaire on implicit bank debt guarantees asks, among other things, what policies respondents have implemented or considered that could be expected to have a bearing on the value of implicit bank debt guarantees, offering a wide choice of policies considered to be representative of the spectrum of choices by CMF participants when discussing the draft questionnaire. It also asks whether the effect of the policy, once implemented, was or is expected to be significant. The key findings from the questionnaire responses are as follows:

- There is no single specific policy measure that could be considered a “silver bullet” capable of fully eliminating the value of implicit bank debt guarantees. While some policies are implemented and currently being considered for implementation more widely than others, no single policy is considered by questionnaire respondents to be a panacea.
- Implementing a mixture of several different policy measures seems to be considered as offering the greatest promise in reducing the value of implicit bank debt guarantees. In fact, the various specific policy choices are seen as complementary, limiting the value of implicit bank debt guarantees through their effects on bank and bank counterparty behaviour.
- Recurrent elements of the mix of policies include measures to strengthen banks through the implementation of internationally agreed capital and liquidity standards and tightening of supervision both in micro and macro prudential terms as well as through efforts to make resolution more effective.
- In fact, there seems to be widespread agreement that the value of implicit guarantees ultimately reflects in particular the smooth functioning of exit mechanisms for failing banks, as the conditions of a potential exit determine current pricing of bank debt and hence also bank risk-taking. The availability of smooth and effectively operating bank failure resolution regimes implies that the value of implicit guarantees is reduced, as, in effect, the capacity (and perhaps also willingness) of policy makers to withdraw the guarantee function is strengthened. Under those circumstances, banks would be less likely to take excessive risks, which in turn would lower the value of implicit bank debt guarantees.
- There seems to be an appreciation of the need for additional measures to those relied on in recent decades to supplement the functioning of market discipline to limit risk-taking. There is growing evidence that these additional measures may include imposing more stringent structural restrictions on bank business lines. The responses to the CMF questionnaire on implicit bank debt guarantees provides only limited support for this approach, however.

While the specific mixes of policies differ among countries in one or the other dimension, there are some common themes that emerge with respect to the overall thrust of the various measures taken or being considered. Asked squarely to describe the overall thrust of the mix of policy measures actually taken or being considered since the pre-crisis period along three dimensions – i) strengthening banks, ii) strengthening the (perceived) capacity or willingness to withdraw guarantees, and iii) charging user fees – considering all policy measures with a potential bearing on the value of implicit bank debt guarantees, the following common themes emerge:

- The overwhelming majority of respondents consider “strengthening banks” as a relevant description of the overall thrust of policy measures taken or considered in their own jurisdictions.
- By contrast, “charging a user fee” for the guarantee – either directly or indirectly and either explicitly or implicitly – is considered a relevant description of the overall thrust of policy measures by only very few respondents. In fact, the responses revealed that respondents felt uneasy with regard to the suggestion to label certain policy measures as directly or indirectly “effectively charging a user fee” for the provision of the implicit guarantee. Comments and discussions revealed that there is a view that charging a fee, even if only indirectly (and implicitly) would nonetheless make more explicit what currently is implicit and that it might undermine current efforts by policy makers to actively dispel the notion that such guarantees exist.
- The third option takes somewhat of a middle ground, although a shift in the overall thrust of the focus of policy actions seems to be taking place, moving from efforts to strengthen banks towards those to strengthen the capacity of policy makers to withdraw the (perceived) guarantee function from banks. Looking ahead, a large majority consider “strengthening the capacity to withdraw the guarantee function” a relevant description of measures planned or being considered.

Survey responses and the results of CMF discussions are consistent with the view that the bank regulatory reform agenda is not finished and that the value of implicit bank debt guarantees continues to be undesirably high, in part reflecting the observation that details of the design of bank regulatory and failure resolution reform are still under consideration and that various measures have not been fully rolled out.

For example, according to estimates discussed by the CMF at its meeting in October 2013, despite some decline, the value of measures of implicit guarantees of bank debt guarantees continues to be substantial, exceeding EUR 50 billion for large European banks. Bank debt continues to be considered special, benefitting from a privileged status, and this situation is undesirable. It was also noted, however, that estimates of the magnitude of implicit guarantees should be viewed with considerable caution, as they are structurally biased in the sense that estimates would tend to be higher for economies that rely relatively more heavily on bank as opposed to capital market financing.

In any case, neither the observed (limited) decline of the value of implicit guarantees nor the persistence where it did not decline are well understood. The decline is certainly consistent with the suggestion that the policy measures already taken or the anticipation of those planned or considered have been effective to some extent in reducing the value of implicit bank debt guarantees, although it might also reflect other factors. As a matter of fact, one key finding identified in the companion report (Schich and Aydin, 2014) is that the effect of policy measures on the value of implicit bank debt guarantees has not been

systematically analysed and that the value of implicit bank debt guarantees is typically not even monitored on a regular basis by policy makers.

The Committee recognised the need to continue monitoring developments regarding the policies that can be expected to have a bearing on the values of implicit bank debt guarantees and the effect on the values of such guarantees. It was suggested the Committee could act as a hub for international efforts to better understand the determinants and limit the value of implicit bank debt guarantees.

Notes

1. Results regarding measurement and analysis of implicit guarantees on bank debt are covered in a companion report (Schich and Aydin, 2014).
2. Schich (2013b).
3. For example, CMF delegates provided several suggestions for additional specific policy categories to be included in the draft questionnaire and suggested that the questionnaire distinguish between measures taken on the one hand and those currently planned for implementation or still under consideration on the other.
4. It also facilitates the separation of different types of bank business operations. In fact, as it helps protecting those claims considered that are considered worth protecting in failure resolution cases (e.g. retail deposits covered by deposit insurance), it was included in the questionnaire under policy category 8.
5. The feedback or response rate as regards implementation of the specific policies differed from one specific policy choice to another, ranging from 17 to 33, mostly between 25 and 28. Response rates were somewhat lower in the part where respondents were invited to provide their assessment of the significance of the specific policy, if implemented.
6. Response rates were slightly lower than for the question regarding implementation or policies being considered. Not all respondents provided a feedback regarding their assessment of significance for each of the specific policy choices offered. As a general rule, the response rate tended to be higher in the case of those specific measures that are related to the implementation of internationally agreed standards.
7. See for a discussion of these developments e.g. Lumpkin (2011).
8. That said, Policy 11 received an even more negative feedback with about 90% considering the policy unhelpful.
9. See e.g. Rosenblum (2014). Referred to as “the Dallas Fed Plan”, one proposal foresees i) restricting access to the financial safety net to traditional depository institutions, ii) requiring financial consumers (other than the customers of these traditional depository institutions) to acknowledge in writing that the government does not provide a backstop for their financial claims and iii) call for government policies that strongly encourage the management of banks to become smaller and easier to resolve so that they would be certified by the FDIC as “Too Small to Save” in the event of failure. According to another proposal, the US Government Accountability Office, together with the Office of Financial Research and Federal Reserve would calculate the value of implicit bank debt guarantees in terms of the implied funding cost advantage and banks would be required to lock up this amount so that it would be available to protect creditors and the FDIC in the event of the failure of the bank.

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