RESEARCH

Regulation Flash

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Economic Analysis

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Resolution Directive and Bail-in:

Removing Government Support in Credit Ratings

On Tuesday – 4 March, 2014 –, Standard & Poor's (S&P) released a report warning of **potential downgrades for European banks** due to the review of the government support criteria in the context of the Bank Recovery and Resolution Directive (BRRD). The S&P review is likely to be completed by the end of April and could result in a gradual downgrade by one or two notches in the next two years – the bail-in will come into force in 2016.

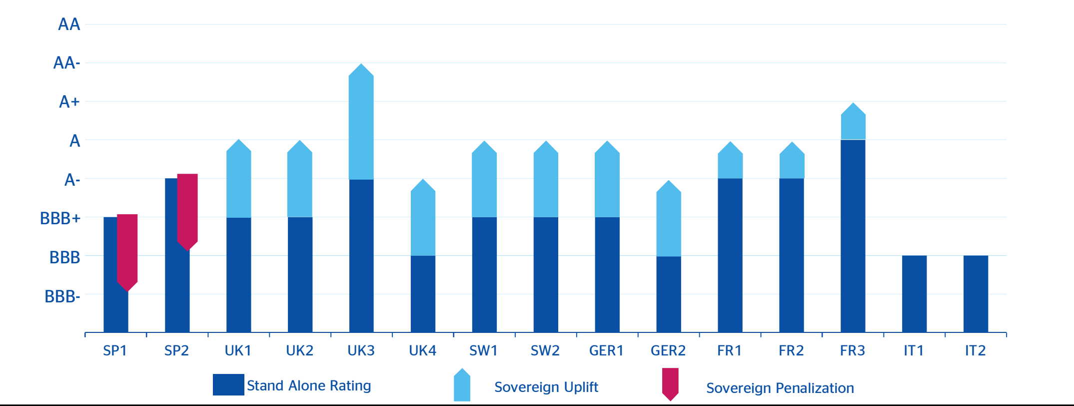
The BRRD and, in particular, the bail-in tool reflect a **new paradigm in dealing with ailing banks –avoiding bail-outs by using bail-ins.** Removing the sovereign "uplift" reveals two effects: i) resolution regimes are credible and predictable, and ii) the bail-in of creditors could become a common practice in case of bank failure. Whether the elimination of parent support will be total or partial will depend on the degree of flexibility that the government retains.

In case of the US, these rating developments have already had a significant impact. In November 2013, **Moody's removed US sovereign support for the eight largest US bank holding companies.** A review of the methodology has shown the progress the Fed and FDIC have made in devising a credible mechanism to implement the US Orderly Liquidation regime.

Removing government support in the bank credit rating would have the following considerations:

- **A positive step forward towards eliminating fragmentation in the European financial sector.** The recent crisis has shown the pernicious effects of the sovereign/banking loop on the European economy. This vicious circle has been reinforced by credit rating methodologies. Chart 1 illustrates this phenomenon, highlighting the different outcomes that sovereign uplifts and/or downgrades provoke on final bank ratings between core and non-core European banks.

Chart 1
S&P Big European banks rating as of December 2013



Source: BBVA Research

- **Each bank's fundamentals and liability structures will become more relevant under the new resolution regimes.** The use of a sovereign rating as the measure of available support and also as the ceiling for a bank rating, regardless of its inherent fundamentals, may create misclassifications across European banks. As a result of the removal of the sovereign rating link, bank creditors should exert more efforts in monitoring their stand-alone credit quality, thus reducing moral hazard and enhancing market discipline.

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