

Should banks be allowed to go into bankruptcy

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Abstract

A report on what consequences bankruptcy's in financial institutes have on society. The group has been equally involved in the making of the report and the views included in the report is the group's mutual opinion

Introduction

Until 2008 Iceland was a small and stable economy, which embraced capitalism and deregulation of the financial market. This helped the countries' stock to grow over 900% within a decade and the banks made a fortune investing in risky foreign markets. Until 2008 Iceland was considered one of the best countries to live in by the UN Human Development index and the country's economy were flourishing. By the year of 2008, however, the foreign debt of the three largest banks in the country had grown over eight times the GDP, and when the global economy started to falter in 2008, so did the Icelandic banks. In October 2008 the largest banks in Iceland went into bankruptcy and the consequences on the countries' economy were severe. The GDP fell by 15% in one year and the Icelandic government found themselves in a massive debt as they had guaranteed a lot of the loans made by the banks. Also, reports showed that, after the collapse, 50% of the young population in Iceland considered emigrating. (The Icelandic banking crisis: Causes, effects & implications, 2012)

In this case the Icelandic government did not have any choice but to let the banks fail due to the high debt the banks possessed, but the Icelandic example shows how severe a banking crisis in a country is. However, usually when big banks start to look weak the government has a tendency to intervene and save the bank by government loans. Interventions like this seems to occur more often in the banking industry than in any other industry, and by intervening the government risks tax payer's money to save poorly managed banks. Is it really right for governments to risk its money to save financial institutes?

The question whether banks should be allowed to go into bankruptcy is a highly discussed topic during the aftermath of the 2009 financial crises, where several big banks got bailed out by the American government. Also during the on-going Euro-crisis the question has been raised several, times, because of faltering financial institutes across Europe.

The topic about whether government should let banks fail is really wide. There are not any methods that governments are set to follow when handling bank crisis, the question is more of a political one where government's political view is most likely to influence them when taking decisions about failing banks. We have in this report, however, tried to enlighten some important terms and aspects that are relevant to the topic.

What happens when banks go bust?

The structure of the banking business is basically to lend and borrow money, therefore creating liquidity within an economy. The more money the bank has tied up in long term loans the more profitable are they, which means that keeping money within the bank in liquid assets is for the bank unprofitable. However, not keeping enough money in liquid assets may mean that the bank cannot honor payments to customers that want to withdraw their money.

Problems usually occur when a large number of people want to withdraw their money from the bank, which has its assets tied up in long term loans and therefore has insufficient liquidity to honor its obligations. The bank needs in this situation a loan, usually issued by other banks or governments, or it will be forced to bankruptcy. This phenomena is referred to as a bank-run and usually occurs when negative rumors emerges throughout the economy. (EconomicsHelp, 2012)

Exactly what happens to the customers of the bank when the bank goes into bankruptcy is that everyone that has savings in the bank loses their assets. However, in today's society governments usually insure up to a certain amount that you will get back even if the bank files for bankruptcy. The mortgages issued by the bank do not get written off. The liabilities for the loans usually get purchased by another company and you still have to pay off your mortgage to them. Losing your assets but not your debts has serious economic consequences for the customer. (EconomicsHelp, 2012)

The consequences from a bank going bankrupt are generally more serious for a country than if an industry company goes bust. This is due to the fact that banks typically involve more players within an economy than regular companies do, therefore influencing more people when going into bankruptcy. Another serious consequence is that if the banking system does not function properly, as it would in the case of one or several bankruptcies, is that the transactions within the economy would decrease as investors cannot take out loans in the same extent as they want.

The banking industry is also characterized by strong interconnections. If one bank fails it is likely that another one of its partner banks also will. This makes the banking business more vulnerable to bankruptcies as people tend to speculate which bank will be next if one bank fails, therefore increasing the probability that another bank will fail. This starts a chain effect throughout the economy that could undermine the whole system and be very severe for the country.

Moral hazard

There are many examples from everyday life which can illustrate this phenomenon. Owning an uninsured bicycle results in a protective behavior as if you lose it or it gets stolen, you will have to pay for a new bicycle yourself. If you on the other hand insure that object, you will have less incentive to protect it from getting stolen. This is called moral hazard, and occurs when the consequences of your behavior is limited. (Economicshelp, 2012)

Facing an economic crisis in 2008-2009, many governments around the world decided to bail out banks considered too-big-to-fail to prevent an economic and financial meltdown. Too big to fail is an expression used to describe a "financial institution which is so large and interconnected that their failure would be disastrous for the economy" (Wikipedia). This means that a government cannot allow it to declare bankruptcy and

are forced to bail out the banks. When banks do not have to suffer the consequences of their risky behavior and bad economic decisions, this sends a signal to the other banks. If one bank is saved, competitive banks assume that if they get into trouble they will also get saved and will worry less about making risky trades. (Economicshelp, 2012)

In the short term, bailing out banks may seem as the only viable solution to prevent an economic collapse of great magnitude. However the bail outs end up providing a sort of a safety net which carries the risk of long term consequences. The lack of financial responsibility for their actions causes banks to participate in even riskier trades, which basically postpone the problems for a period of time. (Economicshelp, 2012)

Risk Prevention

After the financial crisis of 2009 concerns were raised once again for new and stricter regulations to prevent another meltdown. Many felt that since banks were bailed out with government finances, stricter regulations should be implemented to prevent another catastrophe. Two of the identified problems were that the banks had grown incredibly large and could therefore not be allowed to declare bankruptcy without global consequences, and that the banks had gambled with more money than they could afford to lose.

After the crash, President Obama stated that “Never again will the American taxpayer be held hostage by a bank that is too big to fail” (Wall Street Journal, 2010). Implementation of regulations with the objective to limit banks from becoming too big to fail would mean that the consequences of a bank’s collapse would be serious, although not threatening to the entire economy. This would mean that the threat of bankruptcy would be credible and force the banks to be more careful with their investments (Economicshelp). Obama suggested “expanding the reach of a 1994 law that forbids banks from acquiring another bank if the deal would give it more than 10% of the nation's insured deposits. However they would not force existing financial firms to downsize.” (Wall Street Journal, 2010)

If the banks are not downsized, further regulations are needed. Mr. Obama suggested introducing regulations with the objective to prohibit banks from gambling with the banks money. Mr. Obama said he wanted to force them to “choose between the protection of the government's safety net and the often-lucrative business of trading for their own accounts or owning hedge funds or private-equity funds”. (Wall Street Journal, 2010)

Regulations have been attempted with Basel II as well as Solvency II but they have proved to be inadequate. Basel III is an extension to Basel II and is to be introduced in 2015 which hopefully will ensure more stability for consumers and the society in general. However implementing new regulations has proven hard to do in a sector that

opposes changes that could possibly diminish their income. If one set of regulations fail, we need to further develop new and improved regulations to prevent us from experiencing another situation like this again. "We simply cannot allow firms to grow large and vulnerable enough to threaten the economy and hold it for ransom, to be paid by taxpayers." (Wall Street Journal, 2010)

Regulations in Sweden

The main reason for the financial crisis in America was loans given out to people who could not afford to pay them back called subprime mortgages. Swedish banks have not had a problem with people defaulting on loans and have therefore historically not insured borrowed capital heavily. However, new legislation in Sweden now demands more capital in order to protect the banks from bankruptcy if Sweden is hit by a housing bubble. (SvD, 2012)

The Iceland case

As discussed in the introductions, the Icelandic country had a big economic meltdown when their largest financial institutes all collapsed at once during 2008. Going in to the year 2008, Iceland's three largest banks had accrued a debt of more than eight times of GDP. When the financial crisis started the Icelandic country took a big hit. The Icelandic government, who had guaranteed the loans issued by the banks, was not able to honor its obligations nor could they issue emergency loans to the banks, simply due to that the Icelandic economy were too small in comparison with the debt of the banks. Therefore, the Icelandic banks were forced into bankruptcy leaving the country in turmoil. The domestic stock market 2009 was 95% lower than it had been in 2007, and Iceland's GDP fell by 14% during the same period. (MoneyWeek, 2012)

To have its banking system fail was, at the time, considered to be one of the worst things that could happen to an economy, and governments in the western world would usually do as much as they can to prevent this from happening. Iceland, on the other hand, simply did not have the money to save the bank and had to let them failed. However, instead the Icelandic government did what it could to save the domestic investors, by saying it would guarantee the assets for its own inhabitants. By doing this they left the international investors to share what was left after the domestic ones had their share. The government also refused to pay any insurance to international banks. In doing this they decreased their credit rating around the world. (MoneyWeek, 2012)

Today, 4 years after the catastrophe in Iceland, things are looking better. GDP has recovered and has grown 6.9% since 2010, which is a significant increase compared to other European countries, and the unemployment rate is also looking better in Iceland than in many other countries around the world. Looking at these data, economist around the world start to question whether allowing failing banks to go into bankruptcy really is such a devastating option. Comparing growth between Iceland and Ireland, an economy

of similar size that chose to bail-out its banks in the crisis 2009, shows that Iceland is actually doing significantly better. (The Economist, 2012)

The Economist, a London based newspaper, suggest that the rest of Europe can learn from Iceland's way of handling the crisis. They write that the costs for letting banks go bust might not be as high as we had earlier thought (The Economist). Moneyweek, another newspaper, also states that Europe can learn from Iceland and says that the decision to rescue the domestic economy instead of saving the banks are the reason for why Iceland is doing better than other countries today. Although, Iceland is a small economy which is different in many ways from the rest of the world, the result from Iceland cannot be overlooked when deciding whether to bail-out banks in the future. (Moneyweek, 2012)

Conclusion

The financial crisis of 2009 affected almost all countries in a world where nations' economies are more intertwined than ever. When one bank after the other went bankrupt, this threatened to destroy the entire financial system and send us into a global recession. Many governments chose to save these banks and financial institutions, which were responsible for the crisis to begin with, with taxpayer's money in order to stabilize the financial system and prevent devastating consequences.

In order to prevent banks from using taxpayers' money as a safety net, governments need to ensure that the banks themselves face the threat of bankruptcy. When the financial institutions are too big to fail and the consequences of bankruptcy could threaten the entire financial system, governments are forced to bail out these banks. Regulations are therefore needed to limit a banks possibility of growing too large, control what they are allowed to do with their assets and they are the only viable option to prevent us from experiencing a similar situation again.

The Iceland case introduces an important aspect to the question on how we should handle faltering banks. It suggests that making the decision to bail-out banks might not always be the right one. This complicates the issue further and makes it harder to reach a concrete conclusion.

Further reading

The topic is, as mentioned in the introduction, very wide and therefore is it hard to mention any specific readings that are directly relevant to the topic. However, if one were interested in the topic we recommend firstly reading the discussions about saving banks in Greece, that is very relevant at the moment. The newspaper "The Economist" also has published several articles that illuminate the topic. It is also interesting to read about Iceland in relation to Ireland, in the aftermath of the 2009 economic crisis. Information about this can also be found at all the larger newspapers.

There are some more academic articles that discuss the topic more thoroughly, but given the time we did not take these into account. A relevant article is “Banks, bankruptcy, and public regulation” written by Uri Dothan and Joseph Williams, which can be found at Google scholar.

Sources

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Other

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