Should banks be allowed to go Bankrupt?

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Introduction

In a market economy banks compete as any other business for profits with the big difference they are the infrastructure of the financial system. If this infrastructure goes down, it can have a huge impact on the economy. The desire for making profits and the knowledge that the banks are system important for the financial system can lead to a bank taking larger risks than they should with in mind that they will be saved if they are on the way to bankruptcy. This will be costly for the taxpayers and when better time comes the banks will again make profits which will be paid out to the stockowners. Therefore, the banking sector needs oversight and regulations.

A bad precedent

Following the last financial crisis of 2007-2008, it's clear that the market mechanisms was not able to solve the problems that financial institutions were facing. The aftermath of Lehman Brothers failure led banking regulators to the conclusion that large systemic financial institutions could not be allowed to fail. Governments felt the only solution to avoid systemic contagion from failing banks was to recapitalize them with taxpayer money. Unsurprisingly, this led to public outcry and from then on bailing out failing banks became politically impossible. Policymakers and banking regulators understood that new stricter measures had to be undertaken in order to avoid tax funded bailouts in the future. The main takeaway was that banks must be allowed to fail without disrupting the financial system.

Fallout from Bank Bailouts during the 2008 Financial Crisis

The 2007-2008 global financial crisis saw numerous large banks around the world approach insolvency.

In Ireland for example, a number of banks faced insolvency in September of 2008. The combined debt owed by these banks was more than twice the country's GDP. In order to

prevent the complete collapse of the Irish economy, the government intervened and guaranteed almost all of the failing banks' debt, placing the risk firmly on the shoulders of taxpayers. Ultimately, the banks' losses were considerable, forcing the Irish government to inject the equivalent of 40% of the country's GDP. This bailout quadrupled the country's sovereign debt, and led to a years-long economic downturn. [5]

In the United States, the federal government spent an estimated $1.488 trillion USD on various programs to mitigate the financial crisis. Much of this money was used to bail-out insolvent banks and companies (i.e. Bear Sterns, the American Insurance Group) as well as to take over failing mortgage companies. While the majority of these investments in the financial system have been, or are in the process of being paid back, the American government is nevertheless poised to have lost around 500 billion USD when all is said and done. [8] The burden of these expenses have been ultimately borne by the taxpayers. Public backlash against this spending has contributed significantly to the shifting political climate in the U.S. in recent years, and was a major factor in the rise to power of the Trump administration. [9]

Bailouts moral aspects and risks

It is complicated to determine the effects of a bailout on the financial system, but large quantities of money are often required to recapitalize a bank with financial problems. If used too frequently it will not be politically sustainable. Without proper regulation and oversight, it is possible the bailout money goes to something it were not intended for. Also, the risk of banks taking on more risk as a result of knowing the possibility of a bailout if their investments goes wrong which is morally bad when using taxpayers money. Why should the banks not compete on the same terms as companies in other branches where the stockowners will take the losses instead? Bailouts impacts bank behavior, the banking system at large and financial stability. There are positive effects such as increased interbank lending which helps to stabilize the interbank market with positive effects for financial stability but the increase in interbank lending may also result in a higher interconnectedness of banks which could induce moral hazard behavior whereby banks increase risk taking because of a higher probability of a future bailout.[7]

Competition, Profitability, Soundness and Regulation

Highly competitive markets ensure high efficiency as competing companies must have a competitive business offering. However, it's not clear that the banking sector inherently becomes more stable with increased competition. Market competition may drive product innovation but some of those innovations may be ill conceived and turn out to be more risky

than they appeared at in an early stage, CDOs for example. Competition also drives down profit margins, making it tougher for banks to build up buffers. Lower margins may also tempt banks to invest depositors money with higher risk than otherwise. Research(1) in favor of increased competition exist, suggesting competitive banking systems to be less prone to systemic crisis and exhibiting increased time between crises. Research(2) suggesting the opposite also exists.

In conjunction with regulation and oversight, increased competition in the banking sector should reduce the risk of banks failing according to the responsible authorities in the EU. In 1974 the Basel Committee on Banking Supervision (BCBS) was founded by the G10 countries to improve the stability and the quality of the banking oversight in the hole world by setting up the BASEL regulations. In the Eurozone the Bank and Resolution Directive (BRRD) together with the Single resolution mechanism (SRM) are the main regulatory frameworks for banking regulation and oversight, they are somewhat overlapping. The Single Resolution Board is the authority responsible for taking action and the ECB and national authorities has a consultative role. At the heart of both BRRD and SRM is the principle of bail-in. This states that shareholders and creditors are the ones who bears the cost in case of a bank failure. This enforces market discipline and makes bank realize they will not be rescued by the taxpayer.

The BRRD is a directive providing a set of regulatory and oversight resolution tools when banks needs to be restructured. This may involve selling parts of a firm to third party on commercial terms, transferring bad assets to an *asset management vehicle*("Bad Bank"). The key objectives, defined in european law, is to:

- ensuring the continuity of critical functions
- avoiding significant adverse effects on the financial system
- protecting public funds by minimizing reliance on extraordinary public financial support for failing banks
- protecting insured depositors, and
- protecting client funds and client assets

The first in the BRRD directive in case of an impending failure is forcing the institution to take appropriate measures themselves, this is partly quantitative such as ensuring buffer capital is sound but also qualitative such as forcing the institution to remove and change senior management, force implementation and recovery plan, changing business strategy, communicating to shareholders and changing operational structures.

The BRRD can in some cases allow *Precautionary Public Support,* which is public recapitalization that the banks themselves need to apply for, whereby governments take part ownership in the bank.

Finally BRRD may implement resolution plans and undertakes a resolvability assessment. If BRRD finds that liquidation or resolution can be done without significant impact on either Financial market functioning, financial infrastructures, other institutions or the real economy and that liquidation is *credible* AND *feasible*, then the institution should be liquidated. Meaning that under the new, current, european framework, liquidation of banks is not seen as a last resort but rather preferred to some extent.

What is a Bail-in?

Consider a distressed bank, which has recently sustained losses larger than its total equity. In a Bail-out, a government injects funds into the bank sufficient to cover all of the losses, bringing equity back up to, or above, zero. In this scenario all of the bank's creditors retain their full assets, emerging unscathed from the bank's failure.

In a Bail-in however, the government instead writes down some of the bank's liabilities to unsecured creditors. Note that of the bank's liabilities, some (e.g. unsecured bonds, bank ownership) are unsecured and thus eligible for bail-in, while others (e.g. secured/guaranteed deposits) are not. These written-down liabilities are then converted to equity, which is used to cover the bank's losses and create new equity.

Thus the bail-in is a method for keeping banks afloat without injecting significant taxpayer funds, while those in control of the bank's risky behaviour bear the brunt of the losses.

The Bail-in Method in Action

Preceding the implementation of the BRRD was the government takeover of the Danish bank Amagerbanken in 2011 [4]. Amagerbanken was a relatively small retail bank with approximately 4.5 billion euros in assets. The Danish government implemented a resolution procedure called 'Bank Package III', which targeted the protection of taxpayers from bank losses. Under this procedure, all equity was written down to zero, and creditors' balances were written down by about half their original value. The government kept the bank's critical functions open for about a year to allow depositors to withdraw their full deposits, and to

slowly sell off the bank’s long term loans. Ultimately, the bank’s creditors ended up recovering 85% of their assets. [5] Through this bail-in the Danish government successfully shut down a failing bank, returned depositors full deposits, and placed the losses firmly on the shoulders of the creditors and shareholders; all with minimal costs to taxpayers. This quick and effective resolution partly inspired the SRM. [4]

On June 6th 2017, the European Central Bank officially declared that the spanish bank Banco Popular Español S.A. (around 140 billion euros in assets) was “failing or likely to fail” due to illiquidity. For the first time, the Single Resolution Board (SRB) implemented the SRM in order to restructure Banco Popular’s liabilities. On June 7th the SRB stepped in, writing down the the assets of shareholders and junior creditors. The SRB then arranged the sale of Banco Popular to the larger and more solvent Santander Bank for the price of 1 euro. As a result depositors’ deposits were fully secured with Santander, while shareholders and creditors bore the brunt of the losses. This action was widely considered a major success of the SRM, as the crisis was resolved without any losses borne by taxpayers. Further, the situation was fully resolved only 4 days after the SRB decided to act. [6]

Worth noting is the fact that as recently as March 31 2017, Banco Popular was fully compliant with all European banking regulations. This suggests that the current regulations may be insufficient as a preventative measure against bank insolvency. [6]

Conclusions

Clearly the focus an early intervention, increased capital buffers and the paradigm of shareholders and creditors being the ones taking the risk in case of failure and liquidation seems to be working at least better than previously, see [3]. Improving regulatory and oversight practices, especially in early stages should provide even better resolution and liquidation results while minimizing negative impact on the financial system and general economy.

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