

DEALING WITH SOLVENCY ISSUES THROUGH BAIL-INS AND BAIL-OUTS: “TOO BIG TO FAIL” AND MORAL HAZARD ISSUES AFTER THE CRISIS

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PROBLEM: BAIL-IN VS. BAIL-OUT



BAIL-OUT VS. BAIL-IN – THE TRADE-OFFS

Bail-in

- Align ex-post returns with ex-ante risk-taking decisions
- Avoid moral hazard (privatizing gains, socializing losses)
- Avoid mis-allocation of resources
- Question: who will be bailed-in?
- Question: is it credible?

Bail-out

- Reduce contagion risks
- Protect financial system from failure of one (important) institution or many at the same time
- Protect small savers and depositors
- Dampen impact of financial crisis and recession
- Question: are we setting wrong signal?

AN ATTEMPT AT A CONCEPTUAL FRAMEWORK

THE BASIC TRADE-OFF

Minimizing external costs

Forbearance
Open bank assistance
BAIL OUT

Ideal

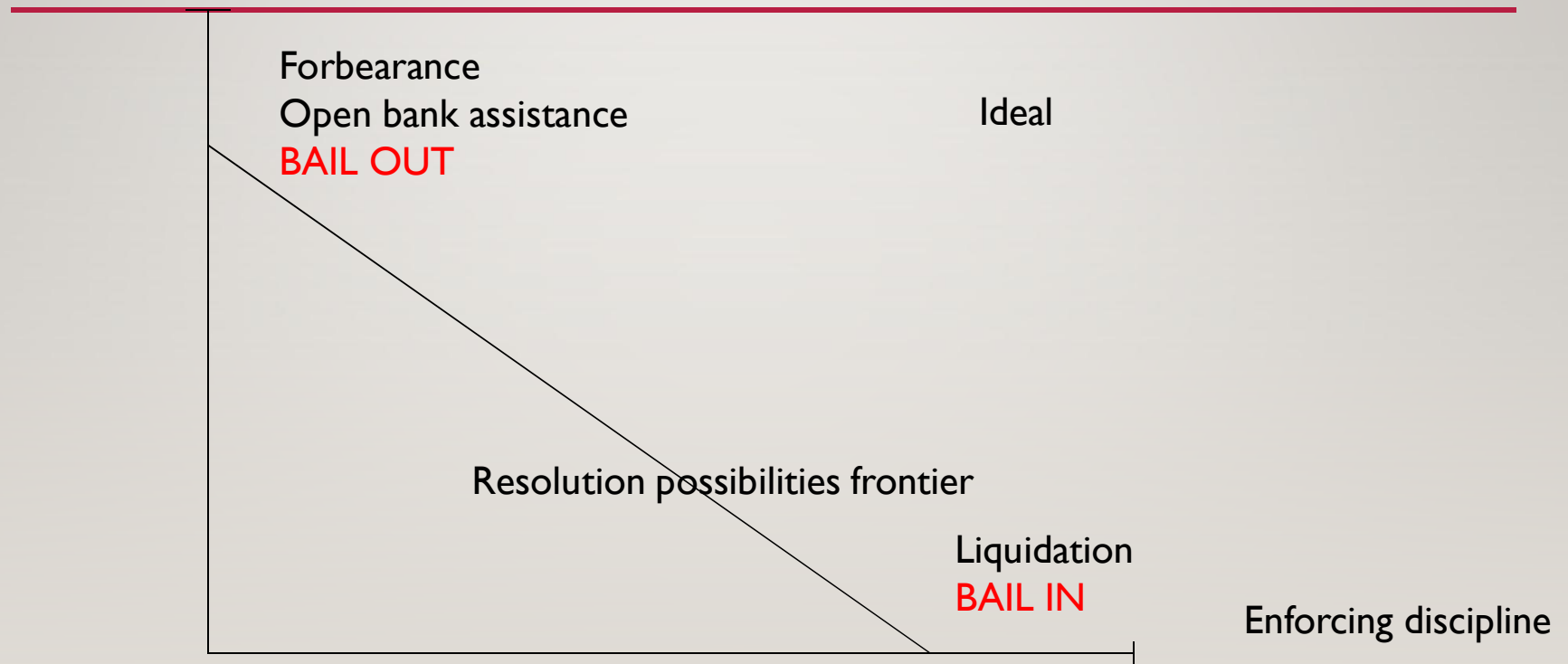
Liquidation
BAIL IN

Enforcing discipline



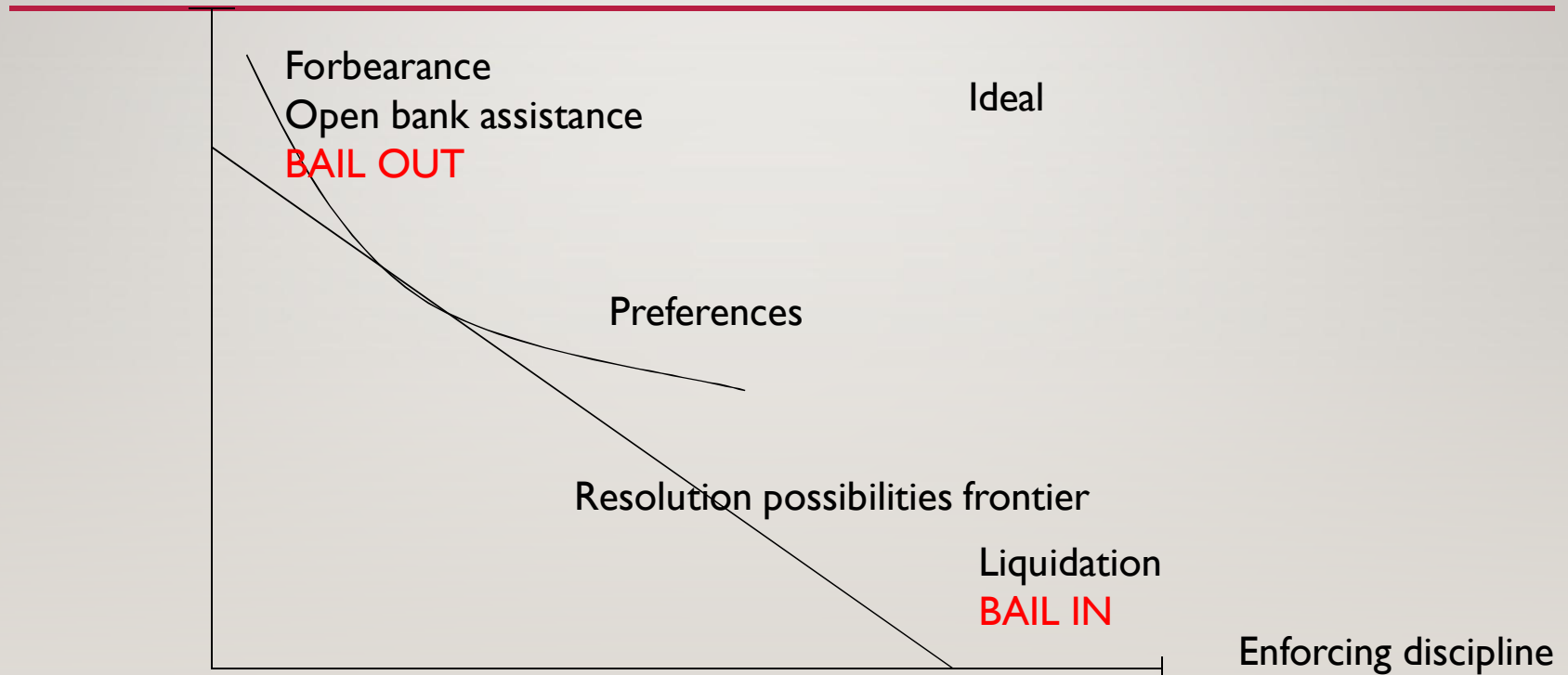
THE BASIC TRADE-OFF

Minimizing external costs

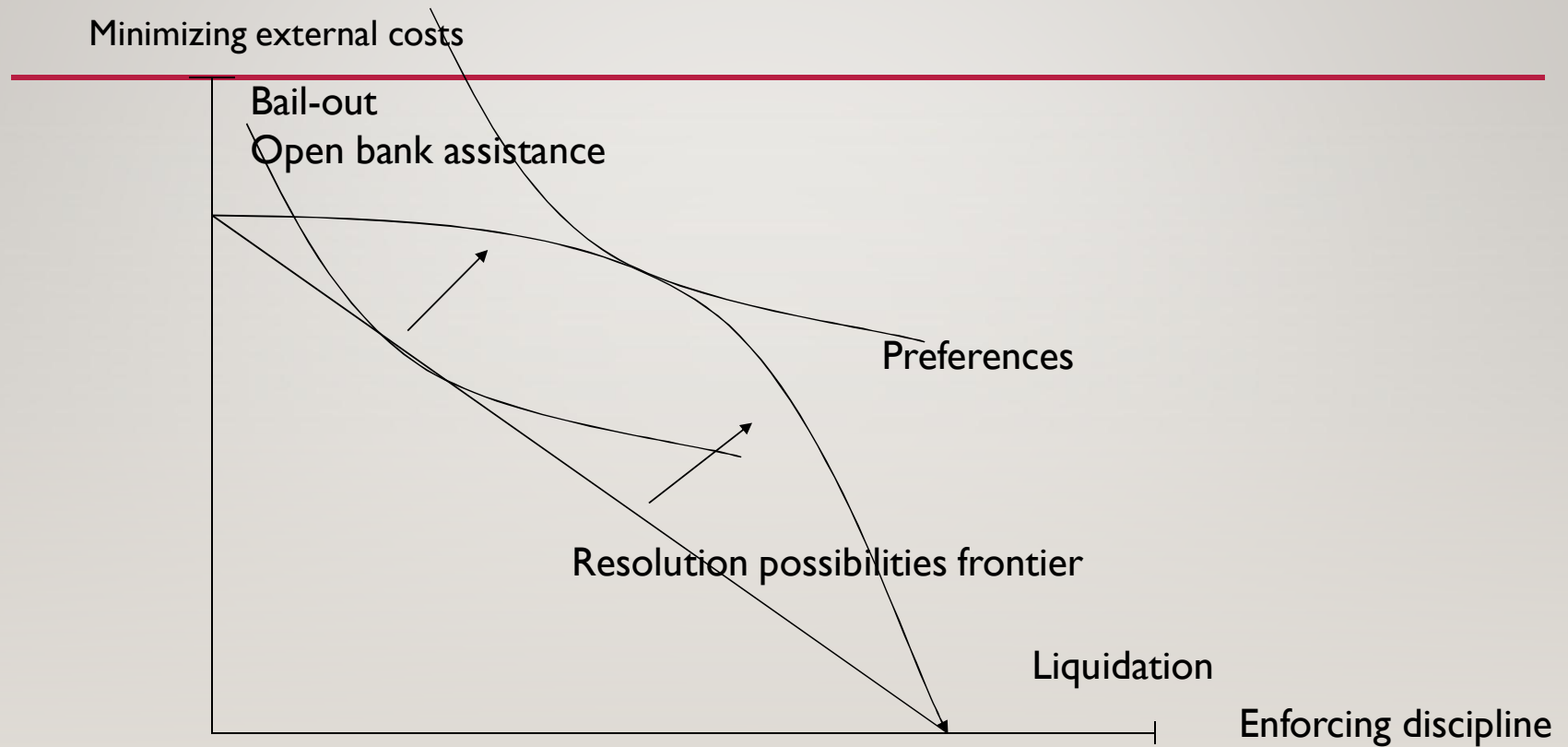


WHICH RESOLUTION METHOD?

Minimizing external costs

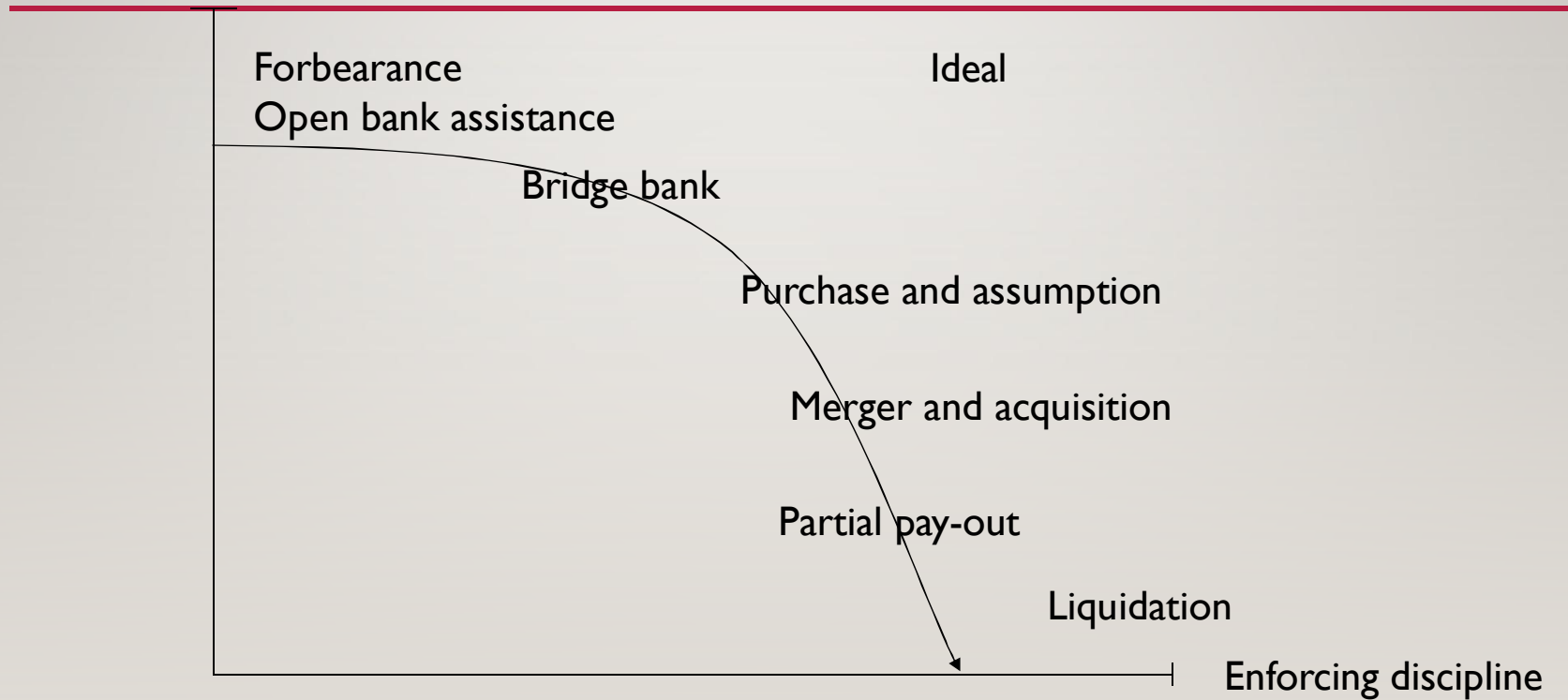


OBJECTIVE: MOVE OUT POSSIBILITIES FRONTIER

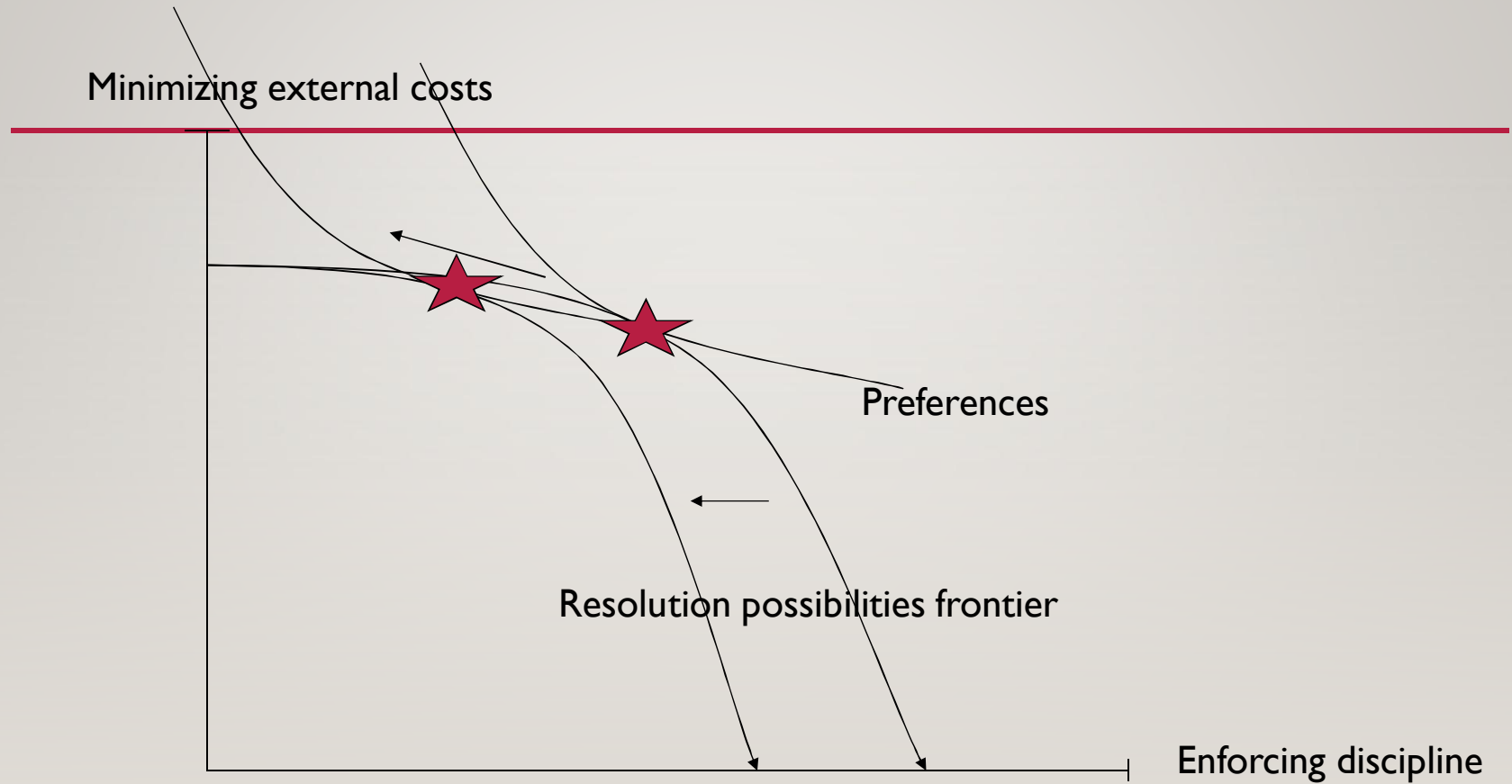


EXPANDING THE RESOLUTION POSSIBILITIES FRONTIER

Minimizing external costs



CHALLENGES IN A SYSTEMIC CRISIS



PROBLEM IN EUROPE

- Legacy problem vs. forward looking banking union
- Geographic dispersion of different interest groups
- Additional level of externalities due to monetary union
- Stark contrast: what is needed (and there is large agreement on it) and what is politically feasible

WHAT ABOUT THE NEW REALITY

What can BES Portugal tell us about the “new reality”?

- National supervisor missing long-standing deterioration
- Bail-in as envisioned
- But: needed to rely on external funding (IMF) for resolution (though repaid)

What can Greek stand-off in 2015 tell us about the “new reality”?

- Sovereigns and banks still closely connected
- Is Italy next?

What can Italian banks in 2016 tell us about the “new reality”?

- Bail-in of retail investors?
- How to recapitalise banks (legacy problems or on-going problems?)

What can the Deutsche Bank “rumours” tell us about the “new reality”?

- Bail-out by German government?



EURO-PROBLEM: LEGACY PROBLEMS



HOW TO ADDRESS THE NPL PROBLEM: EUROPEAN RECAPITALIZATION AGENCY

- Mathias' idea of BRRD holiday
- Temporary asset management company to restructure and resolve weak banks across the Eurozone
- Could be housed at ESM
- Where possible, banks should be recapitalized through the market
- If not feasible, recapitalize by taking an equity stake
 - Receive upside as well!
 - Bail-in of junior and possibly some senior debt holders
- Need for fiscal backstop from ESM

SUMMARY – ARE WE THERE YET?

- Long regulatory agenda remaining
- BUT: banking union necessary not sufficient condition for Single Market in Banking
 - Move from national to Euro-banking system
- Mathias: “*when bailout is out and bail-in is not in, denial is the only option left*’ ... And procrastination is also very costly for growth and thus taxpayers.”
- Yes, regulators are there, politicians not quite yet!

THANK YOU

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