Should member states be allowed to bailout their own banks?

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1 Introduction

The 2008 financial crisis and its aftermath caused many financial institutions to be on the brink of collapse. A significant number of these then received financial aid from their governments, i.e. they were "bailed out". Gerhardt and Vennet (2017) found that a total of 114 banks were provided with government support between 2007 and 2013 in Europe alone.[1] Furthermore, in the period from 2008 to 2010, a funding to financial institutions of over €4.5 trillion (about 37% of EU GDP) was approved by the Commission.[2] In response to this, a framework of a Single Resolution Mechanism and a Single Resolution Fund was introduced in 2014 with the intention of unifying rules and procedures regarding failing financial institutions that would prevent future bailouts funded by money from taxpayers.[3] We defend the motion that member states of the European Union should, under certain circumstances, be able to bail out their own banks with disregard to the newly implemented rules.

2 Our arguments

Too big to fail

- Certain banks are simply "too big to fail". This means that their bankruptcy would entail significant macroeconomic losses.
- It is important to state that bailing out a bank does not only mean saving the bank itself, which might be important, but mainly protecting the stability of the whole financial system. Indeed, it has been shown empirically using a difference-in-differences analysis of the US TARP programme, that bank bailouts in times of crisis significantly reduce systemic risk, i.e. increase the stability of the financial system.[4]

EU disregards regionally significant banks

- It should be noted that EU "emergency mechanisms" that are meant to save important banks apply only to banks that are deemed significant according to specific criteria.[5] The message of the EU towards regionally significant banks is that they should just be wound up in insolvency proceedings. However, in an economy such as the Italian one, the banking system is actually based on such smaller banks. In case of their winding up, a chain reaction might follow, damaging the regional and even the national economy. Therefore, smaller banks still *must* rely on help - a bailout - from the government, since the EU system disregards them even if their failure could result in a national crisis.[6]

[1] Gerhardt, M., and Vennet, R. V. (2017). *Bank bailouts in Europe and bank performance.* Finance Research Letters, 22, 74-80.

[2] European Commision (2012). *New Crisis Management Measures to Avoid Future Bank Bail-Outs.*

[3] Regulation No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

[4] Berger, A. N., Roman, R. A., and Sedunov, J. (2016). *Do bank bailouts reduce or increase systemic risk? The effects of TARP on financial system stability.* Journal of Financial Intermediation, Forthcoming.

[5] https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html

[6] Smith, J. (2017). *The gaping contradictions in EU bank bail-out law and policy.* retrieved from: http://www.primeeconomics.org/articles/the-gaping-contradictions-in-eu-bank-bail-out-law-and-policy.

Protecting uninsured savings

- In case of a "bail-in" procedure, which is the alternative to either bailout or bankruptcy, the bank is not saved using public money, but rather by that of the creditors. This means that the deposits in the bank are in danger of potentially being used to cover the banks losses. The uninsured portion of deposits could therefore be lost. This is exactly what happened in Cyprus in 2013.[7] Since state-uninsured depositors are typically other large financial institutions or companies (they tend to have deposits in excess of the threshold of €100 000), this might result in capital flight.

- Moreover, larger deposits of private persons are wiped out. Besides the questionable morality of such an event, it significantly decreases the trust in the financial system, thus damaging the whole economy.[8]

Prospect of future benefit

- In the past, we have seen a number of times, for example in the cases of the United States and France, that a stakeholder bailing out a company on the verge of bankruptcy profited from the help in the long run through dividends payed out to the stakeholder as part of their preferred shares given to them in return for the bailout and refunds.[9]

- Of course, for this direct benefit to be possible, it is necessary to ensure that bailouts are not provided to entities "free of charge" but they are obligated to pay back their debts, at least partially, instead. This further ensures that the moral hazard problem of bailing entities out is minimised as was proven in a study of 3 517 German banks.[10]

3 Expected arguments from our opponents and our counter-arguments

Costs to the government

- It can hardly be argued that bailouts come without costs to the government. However, these costs are largely influenced by the political economy and the institutions of a given country. It was shown by Grossman and Woll (2013) that in countries where negotiations with the banks worked on a more collective basis and where the state had more of a say on how the bailout would proceed (i.e. Denmark and France, as opposed to countries such as UK and Ireland), the private sector shared the costs more and the bailout was significantly more efficient and successful.[11] It can be argued that Italy belongs to this group of countries and can easily adopt a largely collective and interventionist approach to bailouts, as opposed to the British "here is the money" approach.

- Further, costs to the state can also be minimised by assuring that the government receives equity in turn for the bailout. Then, the government is not giving away a gift to the bank, but rather buys parts of it. When the bank subsequently reaches good financial health, its parts can be once more privatised, with the government reaping the benefits. In this way, in its 1992 financial crisis, Sweden was able to reduce the cash cost of the crisis from 4% of the GDP

[7] World Bank (2016). *Bank resolution and bail-in in the EU : selected case studies pre and post BRRD.*

[8] Brown, M., Evangelou, I. S., and Stix, H. (2018). *Banking crisis, bail-ins and money holdings.* retrieved from: https://voxeu.org/article/banking-crisis-bail-ins-and-money-holdings-lessons-cyprus.

[9] https://projects.propublica.org/bailout

[10] Dam, L., and Koetter, M. (2011). *Bank bailouts, interventions, and moral hazard.* Bundesbank Series 2 Discussion Paper No 2011, 10.

[11] Grossman, E., and Woll, C. (2014). *Saving the Banks: The Political Economy of Bailouts.* Comparative Political Studies, 47(4), 574–600.

to 2.1% of the GDP.[12] This Swedish bailout is considered by commentators to be a success story.[13]

Centralisation

- Free market is often considered to be one of the most important structures that needs to be relished for the benefit of all. A bailout by the government while neglecting the Banking Union rules, however, counters this principle as the government chooses the entities to be bailed out without applying a general rule. Instead, certain entities are chosen to be helped with their problems and they are expected to act in a certain manner as a consequence. This way the government centralises the free market in a possibly unwanted way.

- On the other hand, many inefficiencies of the free market are known to prevent or diminish economic growth. If the government chooses to help an entity after conducting a detailed cost-benefit analysis, it is likely that the effect of the bailout in the long run will create the highest possible good in terms of monetary impacts. The help must be decided individually based on both firm-specific and state-specific factors. Furthermore, the business cycle might be an important determiner of what the help can achieve or cause. While bailout of a firm in an economy that is slowing down might hurt everyone involved, the same help provided to the same firm right before the peak of a cycle might ensure an even bigger growth and less hurtful downturn. Applying general rules and non-involvement of the government in market affairs thus cannot be always considered the ultimate way to operate.

Moral hazard

- Schiozer et al. (2018) show that an increase in probability of bailout in case of emergency directly results in riskier business undertaking of banks.[14] A large-scale help that goes against current regulations might thus endanger the future of a sector because of similar entities operating within it might expect the same measures to be taken in case of them failing and change their behaviour accordingly.

- At the same time, an analysis in a paper by Dam and Koetter (2011) provides empirical evidence that moral hazard and its impact on risk-taking behaviour can be mitigated with the use of selected interventions intertwined with bailouts such as establishing penalties aimed at the management of the company that is being helped.[15] Furthermore, it is shown that simple warnings that are being used most often are ineffective at reducing moral hazard. Given that a proper and effective method is used, this unwanted effect of bailouts can be resolved.

[12] Drees, B., and Pazarbasioglu, C. (1998). *The Nordic Banking Crisis: Pitfalls in Financial Liberalization?*. IMF Working Paper No. 95/61.

[13] Dougherty, C. (2008). *Stopping a Financial Crisis, the Swedish Way.* retrieved from: https://www.nytimes.com/2008/09/23/business/worldbusiness/23krona.html?_r=0.

[14] Schiozer, R. F., Mourad, F., and Vilarins, R. S. (2018). *Bank Risk, Bank Bailouts and Sovereign Capacity During a Financial Crisis: A Cross-Country Analysis.* Journal of Credit Risk.

[15] Dam, L., and Koetter, M. (2011). *Bank bailouts, interventions, and moral hazard.* Bundesbank Series 2 Discussion Paper No 2011, 10.