REVIEW OF GOVERNMENT BAILOUTS OF FAILING BANKS

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Abstract

Since the Great Depression and the stock market crash in 1929, the global economy has experienced immersive development. This paper will analyze the effects of the involvement of governments in rescuing failing banks through different methodological tools. The purpose of this research is to fill the gap that exists in the literature on these issues and raise awareness of the moral hazard that is increasing over time world-widely. Findings and evidence are presented from one of the methods used to discuss the government stance and/or whether the government should intervene in the period of crisis. After presenting the arguments, the application and usefulness of this paper to data collection will be presented in relatable content.

Key words: *Bailouts, Financial institutions, Financial Crisis, Moral hazard, Systematic risk,*

JEL Classification: *G01, G15, G21, G2, G32*

I.INTRODUCTION

Throughout the history banking sector was tested through different crises. As a result, we have banks which were structured in a way that they can respond to a variety of crisis more efficiently and effectively decreasing the risk systematically. As the prevention against these crises, policies were created to mitigate issues that were the result of unsupervised financial bodies that are controlling citizen's welfare and the capital. Banks are earning profit by leveraging money in terms of loans, charging interest rates on these loans from the borrowers. While at the same time, the bank is using money deposits from the savers who are in a desire to increase the wealth by accumulating interest rates on these savings, over time. In order to decrease the risk, banks are diversifying investments to different investments, hedge, pensions, and mutual funds (Halilbegovic & Sabic, 2018).

Over time, due to poor choices and decisions made by banking investors and managers, the systematic risk was increasing and it leads to some of the major crisis starting for the beginning of the 20th century and The Great Depression which represents the worst economic crisis remembered, leaving millions of people in despair and poverty. Governments around the world created the governing mechanism called Central Banks intending to create and impose rules and regulations to the banks preventing any future crisis and handling conflicts inside their domain.

The central banks are perceived as an upper body, controlled by the government, which can rescue failing banks of closure, preventing the greater impact on the general society (Hoggarth, Reidhill et al, 2004). Apathetic relationship between banks and regulators often results in "information failure", where one party possesses a greater amount of information than the opposite party on the bad credits in the financial statements, producing the moral- hazard behavior, which ultimately leads to bank's liquidation or the government bailout. (Mitchell, 2000)

"Too-big-to-fail" is a concept constructed around the expectation that the failure or the liquidation of the bank will disrupt the economic system and stability of a country. When the government notices first signs of insolvency, regulators present the number of strategies on how the bank can rescue themselves from failure. Usually, the first step is to activate private banks and encouraging them to purchase and save them (Acharya and Yorulmazer, 2007; Brown and Dinç, 2009). In case that mechanism fails, the government decides on a strategy of the nationalization of banks, based on the potential possibility of losing the all capital investment or just part of it (Allen and Gale, 2000).

When a crisis happens, policymakers around the globe must respond on questions, such are:

1. Based on what segment the government will choose whether to acquire the bank or let it liquidate?
2. What mechanisms need to be activated to rescue a failing bank?
3. Should the government prolong the process of the closure or the acquisition of the bank if the resolutions are not working?

This research paper is going to argue the government's involvement in rescuing failing banks using case studies as a methodology tool where from each case study will be taken out facts that are going to be analyzed and compared in order to answer the question, whether the government should bailout the failing business or not.

Also, it will be discussed and reviewed many different mechanisms for resolving crises.

II. FINANCIAL INSTITUTIONS AND CRISES

Before the financial and banking crisis, there are not many mentioning of bailouts in the available public literature. The first one who wrote on the topic of bailouts was Professor Cheryl Block, providing the outlines on developing "Public Bailout Policy". Block (1992) showed the evidence that supports the argument that government bailouts produce negative unintended consequence on the insurance schemas.

As a reaction to the financial crisis, there is a huge interest of scholars to write and discuss bailouts and its forms of implications on the financial system and also on the specific sectors.

A financial institution is accumulating the capital, which grows over time, and they eventually "too-big-to-fail". The closure or the liquidation of them would present a major threat different segments of everyday life, but a domestic economy and businesses would be the most affected. The government's main role, historically viewed, was to prevent the collapse of a financial system, providing them with a sense of security in terms of bailout guarantees. Due to this action created by the government, Professor Jeffrey Manns suggests the introduction of a set of rules which will limit bailouts. One of these limitations is that bailout guarantees are encouraging big sized institutions to make riskier investment and systematically increase the risk. This is worth noting since other scholars such is (Kornai et al. 2003) supported a similar claim.

The exaggeration made from bank regulators in the post-crisis analysis indicates that not everything was done accordingly to policies. Scholar Edward Kane argues that this was done for increasing personal benefits and maintaining the influence among peers. The study would be more useful if it had recommendations proposed as the solution to this problem. However, Minsky (1971, 1982) correctly argues that untrusty and dishonest managers are not the main cause of the issue and that it could potentially be prevented by having more responsible upper management with better and stricter rules and regulations (Halilbegovic & Ertem, 2020).

Some strategies are proposed in recent years in order to split-up large financial institutions into smaller ones in order to decrease the dependence of the great number of people to few institutions that are making generally high-risk investments and decisions (Wessel, 2009: A2)

III. TOO BIG TO FAIL: IS IT WORTH IT?

There aren't many benefits which are supporting the term "too-big-to-fail", except that they are reducing systematic risk. A weakness with this argument, however, is that we cannot find a piece of single evidence where there was a chain reaction of closing financial institutions, as the result of closing on one of the TBTF banks. This is worth nothing as there are many cases where the banks could fail without leaving a negative impact on the financial sector. Ennis & Malek (2005) confirmed in his study that there is not enough evidence that can confirm the connection between "the pattern of behavior (of bankers, policymakers, and creditors) linked to bailouts."

Moosa (2010) in his article summarized the list of arguments about the continuous usage of bailouts and against the term "too-big-to-fail":

- Political bodies are holding the power of classifying a financial institution as a TBTF institution.
- The money used in the process of rescuing a failing bank can be spent to improve prospective sectors in the economy.
- The government is promising TBTF the protection against the liquidation or closure while encouraging them to make irrational and risky decisions.
- TBTF doesn't contribute to long-term stability, due to the other institutions having less incentive to prosper.

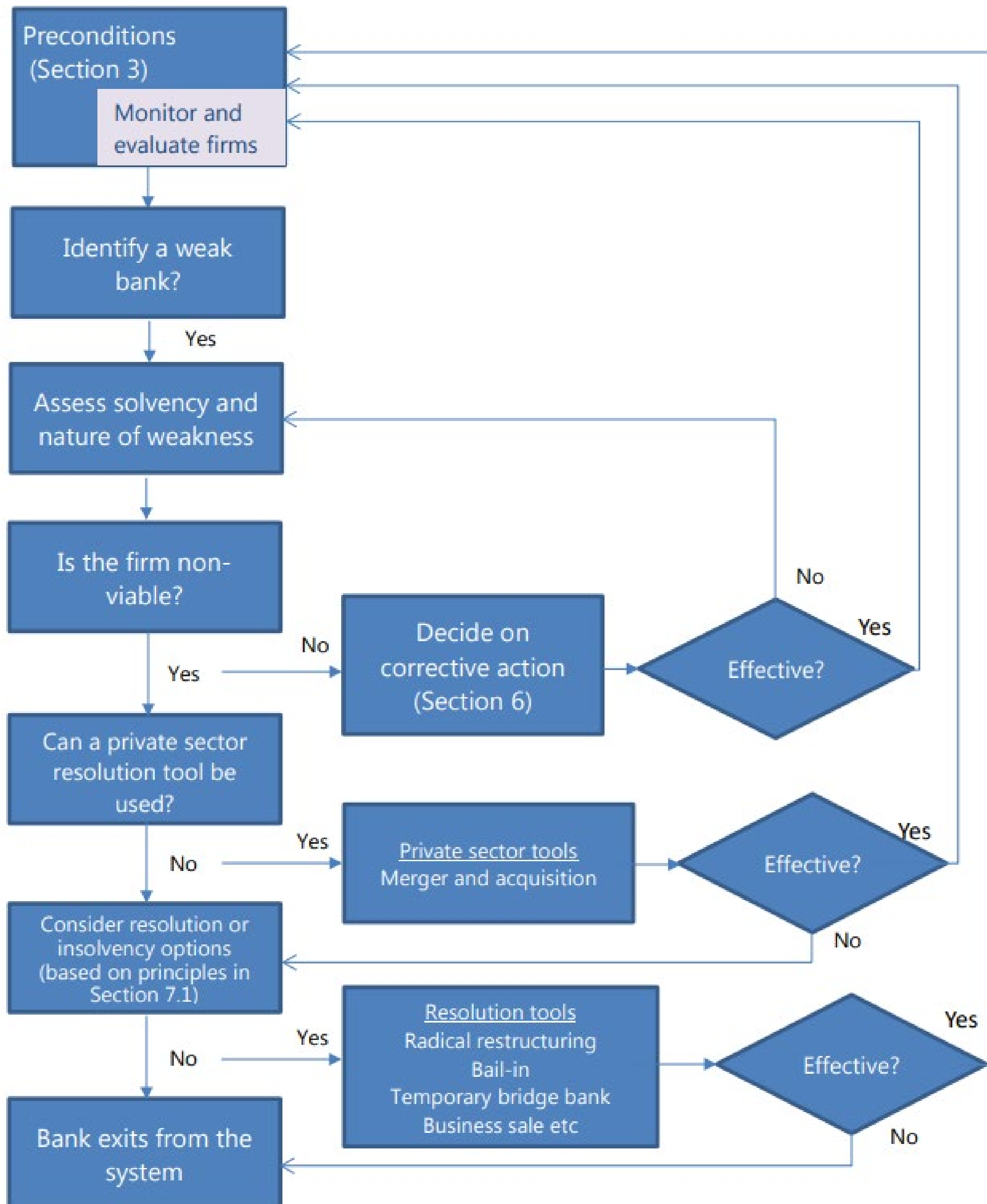

Figure 1 - Flow chart to assist in the resolution of failed banks

The flowchart, shown as Annex 1, is used as a guideline for managers who are dealing with the on-going crisis. It helps to decide what steps the manager has to take to resolve the problem. Asking the right questions and choosing the corrective tools are used to mitigate the problem, are more efficient and more effective.

IV.METHODOLOGY

For the purpose of this research paper case study methodology will be used to investigate more complex examples from the practice within their circumstances. It is significant way to study the theory, evaluate results and develop further actions (Baxter & Jack, 2010). Case studies of this papers explain examples of Government interventions from United Kingdom, Cyprus and Greece. Information gathered from each case study is then analyzed and evaluate in order to create greater picture of what is done in practiced and whether it had positive

results. From the results of this analysis, recommendation for the future actions can be produced.

V.CASE STUDIES: EXAMPLES OF GOVERNMENT INTERVENTIONS

THE UNITED KINGDOM

In 2013, the Co-operative bank announced the capital shortfall. The bank and bank holder decided to take the path of reliving the failing bank, introducing a commercially negotiated consensual bail-in. This way of proceeding transferred the burden of cost from the taxpayers to bondholders and depositors, resulting in the same outcome as "bailout". Problems manifested after Co-op Bank's takeover of the Britannia Building Society in 2009, increasing the systematic risk of extensive lending. These issues only grew worse when Co-op Bank decided to bid for 600 Lloyd’s branches.

Furthermore, the decision was made to use a debt-for-equity exchange option, in which bondholders are swapping debt for new bonds and equity in the bank.

Co-op bank hoped to accumulate 1bn pounds in new assets in 2013, with an additional 500 million pounds, the following year. However, they failed to raise 1.5bn in capital required by the Prudential Regulation Authority (PRA) placing them with the Lower Tier 2 bondholders, directly depositing 125 million pounds by the end of that year. A positive outcome of using a consensual bail-in, realized them from a set deadline, in contrast to a bailout. This ultimately gave them more time to develop and adjust to impose regulations to complete the process of recapitalization.

CYPRUS

In 2013, Cyprus accepted a proposal of recapitalizing the biggest bank, Bank of Cyprus using the bail-in method, while at the same time merging it with the second largest, Laiki bank. Uninsured depositors were summoned to recapitalize financial institutions, introducing controlling measures on capital spending.

One of the main reasons, why Cyprus requested assistance was due to low capital shortcomings. This was caused by Cyprus’s involvement in a restructuring of the Greek debits, through “private sector involvement” resulting in compelling loses holding back their bonds.

Europe Union with its finance ministers presented the new resolution for rescuing failing banks. They offered a 6.75% tax for "insured" depositors and 9.9% for "uninsured" depositors. To everyone surprise, they have rejected the proposal and leaving the banking system closed for two weeks. Meanwhile, the parliament swiftly giving the green light to the new law, used as a legal basis for new changes, allowing the Central Bank of Cyprus to mitigate the problem of insolvent banks. The sudden bail-in of depositors was recognized as unfair and immoral, especially because certain households and enterprises were holding loans and deposits at different banks, at the same time. Only deposits were available for the bail-in, contrary to loans.

GREECE

The capital and liquidity of Greek banks presented the main obstacle in restructuring the sovereign crisis. Regulators along with Greece created and implemented harsh fiscal policies. The bank liquidation was disrupted gradually and in addition to the decline of Greece credit ratings and they were fazed-out of the global market. The main resulted of this policy was creating 14 objectives with 40% of a decrease in the number of banks in Greece.

After the request for the financial aid from the Greek Government, the Member States and IMF approved EUR 75bn heavy adjustment support program for domestic banks. In 2015, financial uncertainty was at its peak which urged the government to hold a referendum, which ultimately leads to "bank holiday” and “the imposition of capital controls.”

Increasing capital requirements was mainly caused due to substandard Greek macro-economic position and the inability to restructure sovereign debt.

VI.RESULTS

THE UNITED KINGDOM

As an aftermath to government interventions in the UK, the cash was directed to recapitalize weak and flawed banks. Portion of that money was used for purchasing portions of HBOS and Lloyds TSB, and of the Royal Bank of Scotland. The government nationalized the entire of Northern Stone and Bradford and Bingley. Additions to that, the two new institutions have been founded:

- “UK Asset Resolution Limited” (UKAR), responsible for managing mortgages and loan portfolio of Northern Rock and Bradford & Bingley;

-“UK Financial Investments” (UKFI), overseeing HM Treasury's shares in Lloyds, RBS and UKAR per their own attentiveness.

The government bailout infused £137 billion of open cash in advances and funding to balance out the monetary framework, the vast majority of which has been recovered throughout the years.

CYPRUS

Cypriot resources of Laiki, alongside the “Emergency Liquidity Assistance” (ELA) and insured deposit liabilities of Laiki, were moved to BoC with the interests in abroad branches and divisions and the uninsured deposits of Laiki staying in an inheritance element. To recapitalize BoC, an expected 37.5 % of BoC's uninsured deposits were changed over into full democratic offers with extra value commitments from the inheritance of Laiki. In order to avoid capital flight, like it happened in the UK in 2007, the biggest piece of the remaining BoC uninsured deposits was block for short period of time. The final decision for the bail-in ("hair style"), was not decided until the end of June 2013, and it was set at 47.5 %. By recapitalizing financial sector, the government is to become one of most important shareholders with an EUR 1.5 billion capital infusion.

Cyprus ended the bailout program in March 2016. So, while the bail-in may be viewed as a triumph it included some significant downfalls. The bail-in included the goal of the two biggest banks to merge with huge costs that are following it.

GREECE

As a result of these policies, the Greek GPD decrease by 26.2%, drastically increasing the unemployment rate from 7.8% in 2008. to 24.9% in 2015. The housing prices plummeted due to increased unemployment, salary cuts, tax increases. As for the main results, it is shown that Greece was one of the first EU members who introduced and passed the law regarding bank resolution that helped the implement resolution measures such is capital control over an extended period of time. By the end of 2015, both the government and private sector raised EUR 63 billion. The era of foreign banks in Greece ended with the acquisition of three subsidiaries by the local bank and the closure of 8 branches. Local banks maintained a strategic distance on the Cyprus banking emergency by purchasing three of their banks.

In August 2018, the bailout program ended. Majority of the debt is owed to the EU emergency creditors, however they have agreed that there won't be any new measures until the debt is paid.

VII. CONCLUSIONS

After reviewing and analyzing different scenarios where countries handled the crisis following a general framework, it is concluded that most of this crisis was preventable. The main reason for the development of crisis is the systematic risk which increases with every irrational decision made by the management. Following that, an intentional overseeing of issues and delaying them leads to an increase in moral hazard behavior. Expecting the government intervention, each time the bank is threatened due to the possible closure, these institutions are hoping for it to happen. This type of behavior is decreasing the commitment to repaying debt and losing the future trust of the general public.

An interesting question arises from the concept of government intervention, does the delay in implementing the intervention measures? The response time seems to be crucial in handling, however, there is still not a model created in the history that can support this. The closest one was Cyprus back in 2013 where the banking sector was closed for two days due to not agreeing on the intervention proposition simply wanting the better deal.

During the financial crisis, experts had an opportunity to analyze how different methodology tools are being used in real-time and to what extent. Fiscal policies created by the end of 2015 are holding very well and maintaining economic stability, which leaves the space for development and growth.

To determine the effects of the bailout in the US, the 2008 subprime crisis will be used in an example. The government accepted the “Troubled Assets Relief Program” (TARP) worth around $700 billion and started bailouts of domestic institutions. The mechanism showed to be right, resulting in profit at the end.

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