Banks: Too big to be bailed out
By Mark Austen, Acting Chief Executive, the Association for Financial Markets in Europe

It was a sight no one could have anticipated. The Lehman Brothers employees carrying their boxes of personal belongings out of the bank’s London headquarters seemed like well-heeled refugees fleeing a financial war zone, still trying to comprehend the events that had turned their world upside-down. Lehman’s size and, more importantly, its trading connections with other firms had made it one of the select group that was widely assumed to be “too big to fail”. But, two years ago next month, it did.

In fact, no firm should be considered too big to fail, but the interwoven nature of the financial system, which provides some of its resilience, also brings one of its weaknesses. The failure of a firm that is systemically important can set off a line of falling dominoes around the system. It was that threat which led the UK and US governments to invest billions to shore up the system, taking stakes in banks such as Royal Bank of Scotland.

While few would still argue that the banks should not have been supported, it is clear that we cannot let this happen again. Taxpayers should never again be the first to be called upon when there is a banking crisis. The assumption that systemically important financial institutions are so essential that they will always be rescued removes a necessary business discipline and absolves management of its
responsibilities. It also distorts competition; after all, where would you put your money – in the bank that is implicitly guaranteed or the one that isn’t?

Banks, like any businesses, must be allowed to fail. But when that failure threatens other institutions and the wider economy we need a way of stepping just before the point of collapse to head off the threat of contagion.

One idea, discussed in our paper, “The Systemic Safety Net”, published this week, is a rapid recapitalisation under which the bank’s creditors would convert their claims into ownership.

There are two likely ways of doing this. Under the first, called “bail-in”, some of the bank’s unsecured debt would automatically convert into equity if the firm hit a pre-agreed trigger, set by its lead regulator. There would be no requirement for the regulators to consult with shareholders or creditors, so a rescue could be mounted very quickly – over a weekend, for example.

The other option is the use of “contingent capital”. This is an investment product, typically a bond, that converts into shares as soon as the firm hits a pre-defined trigger point - in other words, before it is teetering on the brink of insolvency and much before it has become legally insolvent. Unlike bail-in, there is no need for regulators to become involved and, as the terms of the conversion are agreed at the time the investment is made, it is a completely transparent process so the market can see what is happening and be reassured.

Either option would be preferable to liquidation. They protect depositors and reduce the impact on employees, since the recapitalisation would enable the firm to continue in business, significantly reducing the likelihood of contagion. Having such mechanisms were in place would help to maintain confidence in the bank’s ability to meet its commitments, which, in turn, would maintain confidence in the other banks that are exposed to the failing firm.
Crucially, there is no requirement under either option for capital support by taxpayers or a pre-capitalised fund for providing liquidity.

In the case of Lehmans, we estimate that had the firm undergone a bail-in the senior unsecured creditors would have recovered 85-95% of what they were owed and the firm might well have avoided liquidation altogether.

Who loses? Principally, the shareholders would bear the loss through dilution or even complete elimination of their equity. That is all part and parcel of being a shareholder. And while the existing management may have a part to play in ensuring that the regulators and advisers have the necessary information to assist them, it is not hard to envisage that a failure of this nature would lead to a change of leadership.

These new ideas are starting to attract interest. The G20 has asked its Financial Stability Board to report on both options at the Seoul Summit in November and there has been interest from regulators in the UK, Europe and the US. As we set out in our paper, there are still legal and technical issues that would have to be addressed, not least of which would be establishing ways of dealing with firms operating in multiple jurisdictions. However, I believe that a resolution and recovery scheme, using bail-in or contingent capital, could not only render the notion of taxpayers bailing out firms that are too big to fail obsolete but also expose the forcible breaking-up of universal banks as a completely pointless exercise.