

# Bank Resolution: Bail-Out or Bail-In?

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## Some History

Most smaller banks resolved by merger, perhaps after a good bank/bad bank split, with bank/state funding for bad bank.

In systemic/large bank case (e.g. Nordics, 1991/92, Iceland 2008), nationalisation, plus, if necessary, preference for (all) domestic depositors.

Liquidation not used for large banks, since WWII, until Lehmans. Then disastrous, though largely because of cross-border complications. Can cross-border issues now be handled? SPE or MPE?

Mergers of a large domestic bank with a foreign bank still possible, but can run into political/cultural/IT difficulties.

Mergers among the large domestic banks now much less likely, because of:-

- a) Competition/concentration concerns
- b) JPM/Wa Mu
- c) Lloyds/HBoS
- d) IT specificity

Liquidation remains dangerous, especially for G-SIFIs, pace Dodd-Frank.

So need for recapitalisation.

## Recapitalisation

Using whose funds? Bail-out or Bail-in?

Some bail-outs successful. Nordics and US (TARP).

Some less successful (RBS. No clear objectives).

Generally unpopular.

- 1) Moral hazard and unfair subsidisation of larger banks (TBTF and ratings/funding costs): Academic criticism.
- 2) Transfers funds from poor and innocent taxpayers to rich and iniquitous bankers. Also large bank creditors may be foreign (Russians in Cyprus) or hedge funds (Iceland), or both: Public and media, not a macro concern, distributional.

So try bail-in of creditors:

## Bail-in

But bail-in programs will also face problems:-

- a) Governance. Will pass more to the less-favoured; Russians in Cyprus; hedge funds in Co-Op in UK.
- b) Litigation. Will worsen.
- c) Burden of loss is a function of speed of intervention, ability to turn-around policies and litigation. Probably worse with bail-in.

- d) Given equal burden of loss, and that it does not get passed to foreigners, why is bail-in less painful than bail-out? Focussed, not dispersed. Krahenen and Liikanen.
  
- e) Bail-in does have ex ante beneficial effects on risk-taking, but are these large (CDS in 2006/7)? But it also has bad ex post effects on procyclicality and contagion.

Bail-in will seem ex ante good, until it turns out to have been ex post bad!

## Moral Hazard

How then do you avoid moral hazard and the unfairness of TBTF?

- 1) Change managerial incentives.
- 2) Try to avoid all bank liquidations.