The new bail-in doctrine:
A recipe for banking crises and depression in the eurozone

Paul De Grauwe
4 April 2013

The most significant effect of the Cypriot crisis is that the rules governing the resolution of future banking crises in the eurozone have been rewritten. According to the new bail-in doctrine imposed by Germany and the IMF, future bailout operations will involve deposit holders. Those who hold deposits of more than €100,000 now know that if their country gets into financial trouble and has to ask for support from other eurozone countries, they are likely to lose part or all of their savings. The Dutch Minister of Finance, Jeroen Dijsselbloem, was honest in admitting that this would be the new “template” for the future. His retraction afterwards alters nothing about this observation.

The new template guiding the resolution of future financial crises will have negative consequences, on two counts.

First, it increases the systemic risk in the eurozone and makes future bank crises more likely. It is not hard to see why. Every time the fear arises in a country that the government or banks may be involved in a bailout, a bank run will occur because depositors will want to prevent the loss of their savings by withdrawing them from the bank. This in itself will lead to more bank runs and will further weaken an already fragile system.

It is important to stress here that these runs will occur regardless of whether financial difficulties beset the banks or the national government. In the absence of a banking union, the fate of both sovereign and local banks in the eurozone is linked in a ‘deadly embrace’. When the sovereign fails it pulls down the banks, and vice versa. Thus, if the fear exists that a member country government is going to need financial support it will now translate into a fear for the banks in that country, thereby making bank runs more likely.

Second, the new template will impose large economic costs on countries subjected to the bail-in treatment. The banking system is highly interconnected. When one bank fails it pulls others into insolvency, including the solvent ones. Banks are central to the payment and credit system and thus add another layer of interconnection; that between businesses using the same payment system. As a result, when banks fail they can drag large parts of the private business sector into bankruptcy. This happened in the 1930s and made the depression so severe. It will also happen in Cyprus now.
Those who devised the new bail-in template ignored the consequences of this template when it applies to banks. They appear to be labouring under the illusion that deposits are just like any other investment, and that holders can be made to pay in the same way as the holder of a bond or a Collateralised Debt Obligation (CDO) can be made to pay when the issuer of these assets runs into trouble. But because bank deposits form the very core of the payment and credit mechanism, when the value of these deposits is undermined by seizure, the payment and credit mechanism grinds to a halt and so does the economy. Economic history is there to testify to the power of that effect.

Several arguments have been used in support of the new bail-in template. The first is that it is necessary to protect taxpayers. The problem with this argument is that it fails to perform a correct cost-benefit analysis. If the taxpayer is spared, this will indeed create a benefit. But forcing deposit holders to take the hit risks creating banking crises that will result in deep economic depression. These will typically lead to much larger costs for the same taxpayers.

In fact, those who forced the new bail-in template were primarily concerned about the German taxpayer, not those in Cyprus today and in other countries in the future. These taxpayers will pay the full price of economic depressions that follow the collapse of banks. But this is of no concern to the German taxpayer.

A second argument often heard to rationalise the bail-in of deposit holders is that it will make the latter more aware of the risks they incur by holding their deposits in a particular bank. This again is considering deposit holding as an investment like any other. In fact, holding deposits is necessary for business; it is not an investment choice. When deposits are wiped out large segments of private business are also wiped out, creating huge collateral damage. The risk in banking should be reduced by other means, e.g. by imposing much higher capital ratios, or by separating investment from commercial banking, not by raising the spectre that deposit holders will lose their shirts in future crises.

One may object here that while the holdings of demand deposits are indeed not primarily the result of an investment choice and are related to economic transactions, this does not necessarily apply in the case of time deposits. The latter come much closer to being part of an investment portfolio. This then leads to the well-recognised problem that banks may be induced by the existence of a deposit guarantee to attract deposits promising high interest rates. This in turn gives banks an incentive to invest in high-return and high-risk projects. Given the guarantee on their deposits, the holders of these deposits have no incentive to monitor the behaviour of bankers.

This is a serious problem but it should be solved by regulatory means. Thus, in order to avoid banks competing for time deposits by paying out high interest rates, regulators could force banks to increase their capital ratios when the interest rates they pay on time deposits exceed a certain benchmark. Alternatively, a cap on these interest rates could be imposed. In fact, such caps were in place in many countries before the great deregulation movement of the 1970s and 1980s. There is no reason why they could not be reintroduced. After all, governments have to intervene in the price setting when the latter creates externalities. In this case paying high interest rates on deposits creates risks for the system as a whole, i.e. risks outside the bank that sets interest rates too high.

A third argument used to justify the new bail-in template is that this is how bank resolutions are organised in the US, and quite successfully so. Indeed, when a bank fails the Federal Deposit Insurance Corporation (FDIC) will typically close the bank and bail in uninsured depositors. Generally, this does not lead to a run into other banks. This is true but these bail-in operations generally only involve small banks. During the banking crisis of 2008 the US authorities did not apply this bail-in rule to the large and systemic banks (except in the case
of Lehman Brothers, with disastrous consequences). Moreover, US banks are embedded in a banking union. As a result, the failings of local banks do not affect the local government as the cost of the resolution is spread over the whole population of US taxpayers.

Why was this dangerous new bail-in doctrine imposed in Cyprus? The main reason is that creditor nations in the eurozone do not want to pay for rescue operations involving banks of debtor countries. The prevailing view in the creditor countries (based on moral hazard thinking) is that the debtor nations are fully responsible for their own predicament, and therefore it would be wholly inappropriate for their taxpayers to support them. Using taxpayers’ money from creditor nations would just invite further recklessness.

The truth is that the responsibility for the euro-crisis is shared. For every reckless debtor there was a reckless creditor. The northern countries were all too ready to provide loans to southerners so as to be able to accumulate export surpluses. The northern countries’ banks involved in these lending operations managed to shift the loan losses to their respective governments. None was subjected to the bail-ins that will now be imposed on the debtor countries.

The recognition that responsibilities for this crisis are shared would go a long way to making it acceptable for the costs of the adjustment to be shared among taxpayers in the north and south of the eurozone. The failure to recognise shared responsibility has led to the imposition of a bail-in template that increases the risk of banking crises and economic depression in the eurozone.

When a banking crisis erupts, authorities have to weigh up two risks. One is the moral hazard risk that will emerge in the future when the banks are bailed out. The other is the immediate risk of an implosion of the banking system when bail-ins are implemented. Governments that have the power to do so will almost always opt for the bailout option when systemic banks are involved in order to avoid immediate costs to the economy, i.e. a deep economic depression. When sovereign governments have to choose between two evils in times of crisis, i.e. a future moral hazard risk or the immediate risk of an economic depression, they will choose the former in order to avoid the latter. It is therefore naïve to think that the governments of northern Europe that now impose bail-ins on the south will apply these on their own banks in a future banking crisis.

The conclusion above implies that in order to reduce the moral hazard risk, the regulation of banks should go much further than what has been achieved today. The imposition of tighter regulation, including much higher capital ratios; a separation of investment banking and commercial banking; and caps on time-deposit interest rates is a better approach than the bail-in option, which will have enormous economic consequences for the countries of the eurozone that have transferred much of their sovereignty to the creditor nations in the north of the eurozone.