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Can European bank bailouts work?

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ABSTRACT

Cross-border banking needs cross-border recapitalisation mechanisms. Each mechanism, however, suffers from the financial trilemma, which is that cross-border banking, national financial autonomy and financial stability are incompatible. In this paper, we study the efficiency of different burden-sharing agreements for the recapitalisation of the 30 largest banks in Europe. We consider bank bailouts for these banks in a simulation framework with stochastic country-specific bailout benefits. Among the burden sharing rules, we find that the majority and qualified-majority voting rules come close to the efficiency of a bailout mechanism with a supranational authority. Even a unanimous voting rule works better than home-country bailouts, which are very inefficient. If we assume additional systemic risk benefits, the efficiency of burden sharing rules comes close to the supranational solution.

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1. Introduction

Financial stability is a public good, as the producer cannot exclude anybody from consuming the good (non-excludable) and consumption by one does not affect consumption by others (non-rivalness). A key issue is whether governments can still produce this pubic good at the national level with today's globally operating banks. The financial trilemma states that (1) financial stability, (2) international banks and (3) national financial policies are incompatible, see Schoenmaker (2011). Any two of the three objectives can be combined but not all three; one has to give. Fig. 1 illustrates the financial trilemma. The financial stability implications of cross-border banking are that international cooperation in banking bailouts is needed.

Financial stability is closely related to systemic risk, which is the risk that an event will trigger a loss of economic value or confidence in a substantial portion of the financial system that is serious enough to have significant adverse effects on the real economy. De Bandt and Hartmann (2002) provide an extensive discussion of the concept of systemic risk. A key element is that a considerable number of financial institutions or markets are affected by a systematic event. In a similar vein, Acharya (2009) defines a financial crisis as systemic if many banks fail together, or if one bank's failure propagates as a contagion causing the failure of many banks (see also Allen and Gale (2000) on contagion). In Acharya (2009), the joint failure of banks arises from correlation of asset returns and the externality is a reduction in aggregate investment.

The 2007–2009 financial crisis illustrates the financial trilemma, with the handling of Lehman Brothers and Fortis as examples of coordination failures (Claessens et al., 2010). The US acted unilaterally, providing an orderly resolution for the US broker/dealer arm of Lehman, but there was no cooperation offered in the resolution of the foreign Lehman subsidiaries, including the major operations in the UK. The Lehman collapse triggered the global financial crisis. During the rescue-efforts of Fortis, cooperation between the Belgian and Dutch authorities broke down despite a long-standing relationship in ongoing supervision. Fortis was split along national lines and subsequently resolved by the respective national authorities at a higher overall cost.

Rodrik (2000) provides a lucid overview of the general working of the trilemma in an international environment. As international economic integration progresses, the policy domain of nation states has to be exercised over a much narrower domain and global federalism will increase (e.g., in the area of trade policy). The alternative is to keep the nation state fully alive at the expense of further integration.

The domestic orientation of the financial safety net is a barrier to cross-border banking, as national authorities have limited incentives to bail out an international bank. This is visible in the results of Bertay et al. (2011), who find that an international bank's cost of funds raised through a foreign subsidiary is higher than the cost of funds for a purely domestic bank.

How to solve the financial trilemma? There is a large body of literature on international policy coordination (e.g., Obstfeld, 2009;

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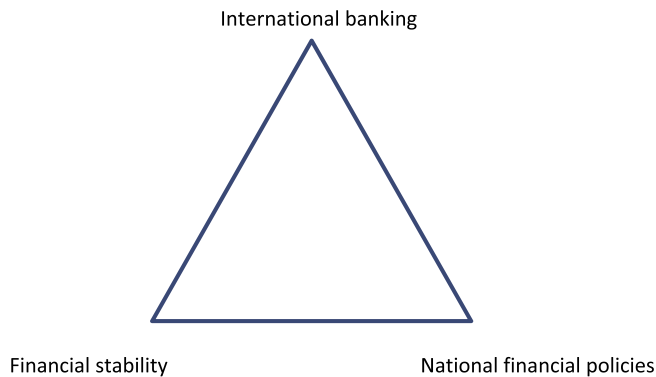

Fig. 1. The financial trilemma. The financial trilemma from Schoenmaker (2011). It states that national financial policies, having international banks and financial stability are incompatible. i.e., these three objectives cannot be met at the same time.

Fischer, 1999; Moshirian, 2008; Rogoff, 1999; Summers, 2000). Broadly speaking, three main strands can be distinguished. The first is to develop supranational solutions, such as an international lender of last resort (Obstfeld, 2009; Fischer, 1999) or a world financial regulator (Eatwell and Taylor, 2000). In this case, national financial policies will be replaced by an international approach. The second is to segment national markets through restrictions on cross-border flows (Eichengreen, 1999). In the case of international banks, the segmentation can be done through a network of fully self-sufficient subsidiaries (Cerutti et al., 2010). The objective of financial integration is given up. This approach is not without cost: the separately capitalised subsidiaries have to operate with higher levels of liquidity and capital in the absence of cross-border transfers. The third is to restrict public intervention to attain financial stability and to strengthen national policies enforcing market discipline (Rogoff, 1999). The argument is that public intervention unduly increases moral hazard. While containing moral hazard is important, the history of financial crises has shown that public intervention can be effective to resolve swiftly a financial crisis in order to resume economic growth (e.g., Claessens et al., 2010; Laeven and Valencia, 2012).

This paper fits in the first strand of developing supranational solutions. Our contribution is that we provide a model to analyse the efficiency of several solutions to the financial trilemma. A first best solution is a supranational approach to financial stability. This approach would be similar to the supranational approach to monetary stability with the establishment of the ECB.[1] Alesina (2003) explains the trade-off between the benefits of economies of scale and internalisation of externalities versus the costs of heterogeneity of preferences of the population. Supranational institutions can perform tasks for which externalities are large, and heterogeneity of preferences low. Applying this criterion to international banks, the externalities are large. Moreover, the preferences for financial stability are homogeneous. But financial stability needs a fiscal backstop, which is politically controversial (Pauly, 2009; and Obstfeld, 2011). Fiscal redistribution within a country with relatively closely-knit, cohesive groups is far easier than between groups of different countries. A second best solution is a binding rule among national governments to share the burden of failing banks in order to maintain financial stability. Following Goodhart and Schoenmaker (2009), we model *ex ante* mechanisms for burden sharing, which are legally binding. The 2007–2009 financial crisis has shown that soft law arrangements, such as Memoranda of Understanding, do not work during a crisis (Claessens et al., 2010).

In this paper we compare the efficiency of the various mechanisms in the European context, as the internationalisation of banking is most advanced in Europe. For the 30 largest European banks, we simulate the bailout probability under these mechanisms; see Van Lelyveld and Spaltro (2011) for an analysis of a sample of international banks. We find that national financial policies cannot produce financial stability for cross-border banks in Europe. The supranational and burden sharing approaches can help achieving financial stability by improving the efficiency of the bailout policy. We are able to derive the efficiency gains for three categories of banks: domestic banks, European banks (operating across Europe) and global banks.

The investigated solutions to the financial trilemma assume international coordination, for which there might not be political support in Europe, see Pauly (2009). Then, the trilemma suggests an alternative of reversing cross-border banking. But a segmented banking system with self-sufficient subsidiaries is costly, as argued above. It may also reduce financial stability at the country level (Slijkerman, 2007; Allen et al., 2011).

Europe is currently contemplating a banking union to foster financial stability. The euro sovereign debt crisis has shown that financial stability cannot be managed effectively at the national level, because of the diabolic loop between national governments and banks. The fiscal position of several European governments is vulnerable, because of the perceived need by the market to back up weakened national banking systems. In turn European banks are in distress because they hold large quantities of debt from these governments. Using daily credit default swaps (CDS) for several euro area countries for the period 2007–2010, Alter and Schüler (2012) provide evidence of interdependence between government and bank credit risk during the crisis.

A truly integrated European-level banking system can do much to stabilise the euro area by breaking this diabolic loop. Beyond this immediate concern, the broader case for the banking union is that national governments concentrate on the domestic effects of bank failures and ignore cross-border externalities. The supranational approach of the banking union incorporates these cross-border externalities. This paper deals only with this second dimension of the current discussion on the banking union.

The remainder of this paper is organised as follows. Section 2 presents the coordination mechanisms in the context of bank recapitalisation with multiple countries. Section 3 introduces a simulation setup to compare the efficiency of the different schemes. Section 4 presents the results. Section 5 concludes.

2. Coordination mechanisms in bank bailouts

We build on the model of Freixas (2003) and Schoenmaker (2011) to formalise the systemic effects of bank failure. The policy instrument in this model is a contribution of funds t by the authorities to recapitalise a failing bank. Our model considers the ex post decision whether to recapitalise or to liquidate a bank in financial distress. The choice to close or to continue the bank is a variable x with values in the space $\{0,1\}$. Moreover, B denotes the social benefits of a recapitalisation and C its costs. Among other things, the benefits of a recapitalisation may include those derived from maintaining financial stability and avoiding contagion (Allen and Gale, 2000; Acharya, 2009). A minor, idiosyncratic, bank failure (e.g., Barings) would pose no systemic problem. If the direct cost of continuing the bank activity is denoted by C_c and the cost of stopping its activities by C_s we only deal with the difference, $C = C_c - C_s$. These costs can also include the monitoring costs that are necessary for the recapitalised bank to stay solvent and keep an

[1] The supranational approach of the ECB is a solution to the monetary trilemma, developed by Fleming (1962) and Mundell (1963). See Obstfeld et al. (2005) for an overview of the trade-offs between fixed exchange rates, capital mobility and national monetary policy.

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