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TOOLS FOR THE RESCUE OF BANKS IN CRISIS

Abstract:

The financial crisis of 2008 drew attention to the insufficient regulation of banks. Due to the bank failures taking place at different places of the world, the crisis significantly decreased the budgetary funds of the countries. Banks too big to fail that had extensively grown due to the previously used practice expected the governments of the countries in which they were established to save them from the money of the taxpayers. However, this process was not sustainable on a long term and mainly after the crisis, and induced the operators to develop a new solution. Not only new legislation was necessary, but new institutions had to be also set up. In the framework of the European Union, the reform was named banking union, and two of its three components, i.e. banking supervision and resolution, are intended to prevent bank failures, and one, i.e. deposit guarantee, is intended to mitigate the damages caused by the failure. This study presents the economic tools used to prevent the failure of banks in crisis, with special regard to the institutional system of resolution. Resolution is a tool for the restoration of the operation of an institution that is becoming or has become insolvent, with the intention to prevent the spread of the problem in order to make sure that the involvement of the institution paying funds in the case of the bank failure is not necessary and the society is affected by the situation to the minimum extent. The national resolution funds as well as the Single Resolution Fund of the EU have been established mainly to reduce the system risk caused by the so-called banks too big to fail, ensuring thereby the stability of the financial system.

Keywords:

banking union, bank failures, too big to fail, resolution

JEL Classification: G21, G28, H12

1 Introduction

The study briefly presents the potential tools of rescue of banks in pre-bankruptcy situation in view of the events of the more than 10 years from the beginning of the crisis. The tools of bank rescue have been reconsidered due to the increased number of systematically important banks. The appearance of systematically important financial institutions is a serious problem of the economic life of the 21st century, for the solution of which new laws have been adopted and new institutions established at both national and international levels in connection with the events of the recent years. Due to the descriptive nature of the study, mainly the available literature comprehensively presenting the operation of the system with reference to the experiences gained in this period has been processed.

2 Connection between the System Risk and Bank Failures

Bankruptcies may be caused by a number of factors. These may include specific problems resulting from the nature of the operation of the credit institution in question as well as external, macroeconomic factors. Erroneous decisions made by the owners and extremely high risks undertaken in the expectation of higher profits are the most frequent specific problems. As regards macroeconomic factors, economic downturn may entail decrease in demand on the bank products via the reduction of the incomes of business investments and of the private sector. (Baka et al., 2012; Ligeti et al., 2019).

Two great groups of banking crises are distinguished by the literature: specific and systemic banking crises. While in the first case the problem affects only the credit institution in question, in the latter case the crisis may involve several institutions (Erdős et al., 2010).

The financial crisis started in the United States in 2007 was an example for the latter one, which has grown into an international crisis, and fundamentally changed the image of the bank system previously considered relatively stable. A significant part of banks in difficulty could be saved only with state rescue packages of the countries in which they were established (e.g. Ireland, Greece). Avoidance of the bankruptcy of big banks is indispensable to prevent severe recession in the country in question and to ensure that the depositors suffer the least damages in the resulting situation. However, as regards Cyprus, the use of the money of taxpayers became unavoidable, which imposed significant burdens on the budget, and the previous sovereign crisis developed into a debt crisis. While in Europe state recapitalisation was the quickest means for the rescue of systematically important banks, in the United States rescue of the institutions via resolution was also applied by the Federal Deposit Insurance Corporation due to the high number of bankruptcies. As a result of the events, the countries of the European Unions have also reached the point, where it was no more possible to rescue the banks from public funds, and the increase of the government debts had to be arrested as soon as possible. The Basel III regulatory programme was launched for that purpose, which specified more stringent capital requirements for the banks. Stricter rules should apply to banks due to the special nature of their activities than to a traditional business. No sufficient protection was provided by the pre-crisis rules against bankruptcy. The new strict capital and liquidity rules are the key means for the avoidance of bankruptcies. The expected minimum capital requirements have been specified to ensure safe (prudent) operation of the banks. The set of measures developed by the Basel Committee of Banking Supervision classifies the banks into groups by size, system of connections and sphere of services, and examines the potential effect of their bankruptcy on the economy as a whole. To continuously control the capital situations of banks, the Financial Stability Board annually publishes the ranking list of globally important financial institutions, which need capital increase to ensure safe operation. Based on the list published in November

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2018, there were 29 systematically important banks in the world, which would have needed immediate capital increase. JP Morgan Chase would need the highest capital increase by 2.5%. Out of the 29 banks, 16 ones are seated in the European Union (FSB, 2018).

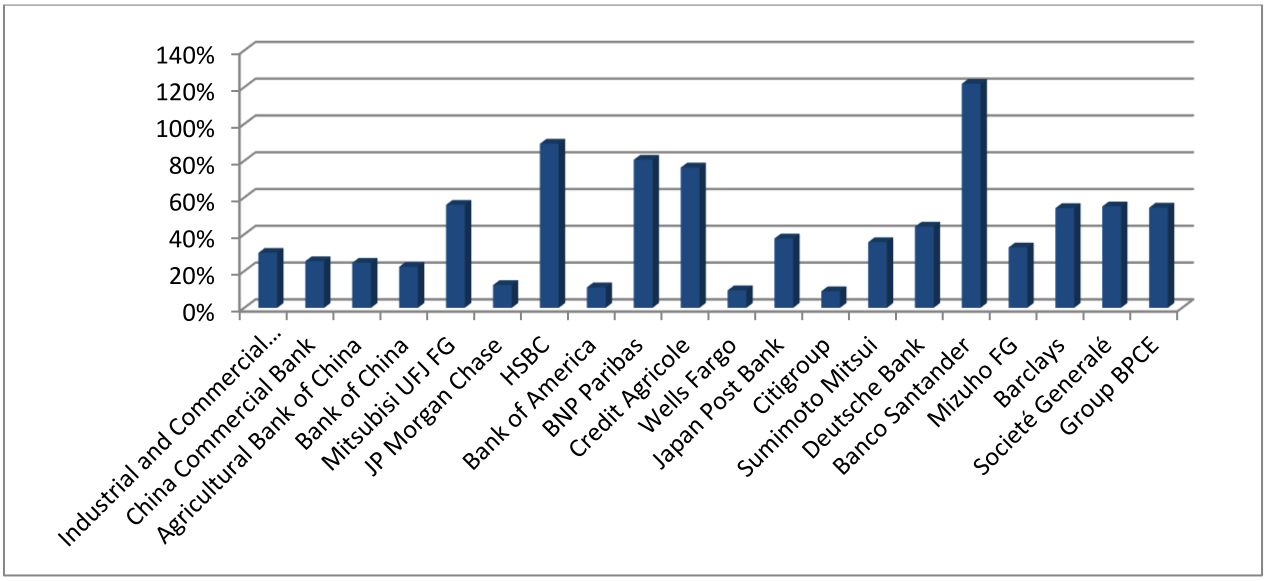
Today, the connections between the financial operators affect all areas of the economic life. There are no geographical limits, and due to the result of organizational renewal supported by the development of information technology (Koloszár, 2013), credit institutions operating at various points of the world can easily contact each other. This resulted in the establishment of significant financial institutions before the crisis, the influence and size of which exceeded the economic weights of certain countries.

"As a result of the growth of banks, by 2008 there were thirty banking groups operating in the world, the external total assets of which exceeded half of the GDP of the country of establishment." (Mérő, 2012. p.15)

The first figure shows the total assets of the 20 biggest banks of the world in comparison to the national gross product of the home country last year, in 2018.

The figure well illustrates that the concentration of the European bank system and the sizes of the banks as compared to the national gross product of the country of establishment exceed the sizes of the bank systems of the United Nations and the Asian countries.

Figure 1: The world biggest banks total assets to the GDP of their home country (2018)



Source: FXSSI (2019), IMF (2019)

The regional concentration of the banks can be also observed simultaneously with the growth of banks. Out of the world's 20 biggest banks, 8 ones are Asian (Chinese and Japanese). Among them, Chinese banks are in the first four places. The other 12 banks indicated in the list include 4 American banks, 4 French banks, 2 British banks, 1 German bank and 1 Spanish bank.

The Spanish Banco Santander has total assets (122%) exceeding 100% of the home country's GDP. The shares of additional 7 European seated banks exceed 50%. However, the Chinese banks have typically 20% shares, while the American banks have less than 10% shares as compared to the national gross product of the country of establishment.

If these European giant banks fail, they would very likely draw the economy of the country of establishment with them. In addition, other institutions and countries would also suffer losses via the so-called infection effect resulting from the complexity of bank connections.

Before the crisis, the owners of the too big to fail banks expected the governments of the countries to save them from the money of tax payers in the case of problems, as they knew that their bankruptcy would cause significant damages to the country's economy, the consequences of which would even destroy it, and a prolonged liquidation procedure would further decrease of the confidence of clients in financial operators. However, this irresponsible behaviour of an owner was not sustainable in view of the events. In the United States, the American government did not save the Lehmann Brothers Bank exploding the crisis, when it failed. The consequences are already known. Due to the closure of the bank, the creditors and depositors suffered significant losses. The process that was induced in the elaborate system of financial connections caused a global crisis in the whole world. Stricter rules have been created in connection with responsibility and remuneration issues regarding the owners in order to reduce excessive risk-taking (Papp, 2015).

3 Means of Bank Rescue

The System of Institutions of Resolution at National and International Levels

"The experiences gained during bank rescues provided by the governments after the global financial crisis of 2008 have shown that optimum results cannot be achieved with the existing means, i.e. liquidation of the credit institution or bank rescue by the government in many crisis situations. A third method, resolution is necessary." (Kómár & Sulyok, 2018 p.46.)

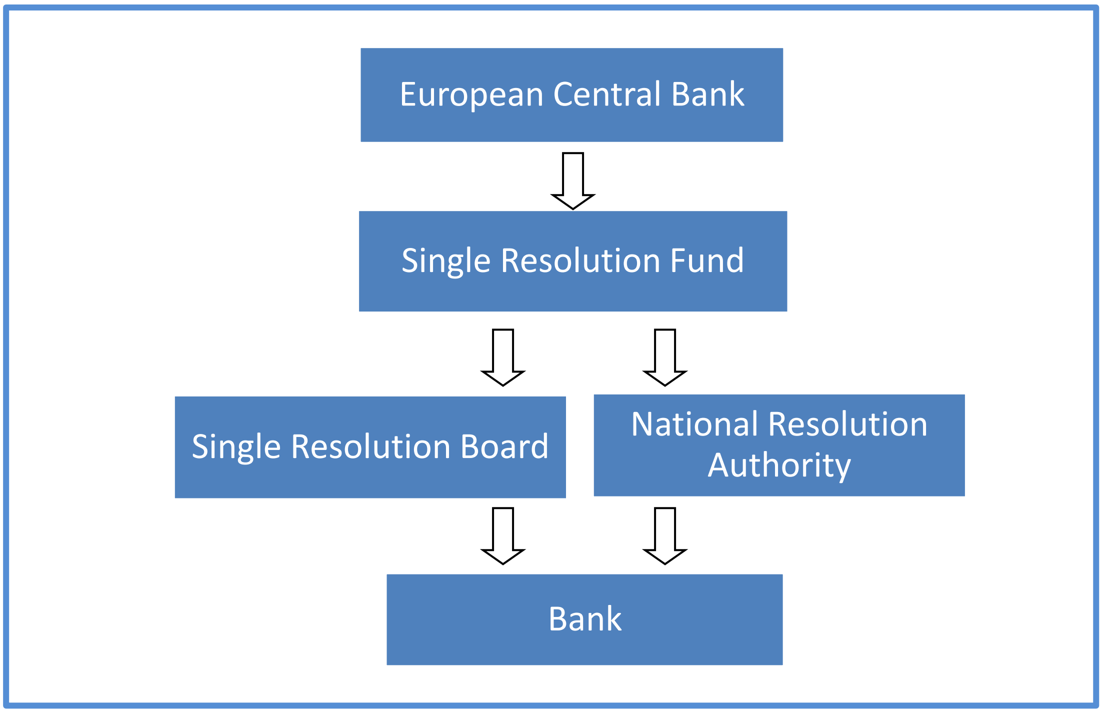
According to definition by the national Resolution Fund, resolution is a procedure intended to reorganise the credit institution that has become or is expected to become insolvent, in order to ensure the continuity of the fundamental functions of the institution, to keep the stability of the financial mediation system and to restore the viability of the institution as a whole or a part of it (Szanálási Alap, 2019).

Requirements related to the single resolution mechanism (SRM) created as part of the bank union are contained in Directive 2014/59/EU of the European Parliament and Council, in accordance with which each member state must establish a national resolution fund (Európai Parlament és Tanács, 2014). In our country, the National Bank of Hungary is the resolution authority established in July 2014. The Resolution Fund does not have a work organisation, its operative tasks are performed by the National Deposit Insurance Fund. The property of the Fund derives from payments of the credit institutions and investment companies, the size of which has been specified in the rate of the insured deposits. The introduction of the single resolution system is intended to promote the rescue of banks in pre-bankruptcy or bankruptcy situation. The system started to operate on 1 January 2016.

The single resolution mechanism created as an element of the bank union offers protection only to the euro area countries, which are automatically members of the bank union. The biggest banks of these countries are controlled by the European Central Bank as a single banking supervisor. The resolution process of the EU is illustrated on Figure 2. The ECB notifies the Resolution Fund if a bank is in bankruptcy situation or needs resolution. Then the Resolution

Body decides if resolution is possible, or the liquidation of the credit institution is unavoidable. Resolution is possible if the bank is or will become insolvent, its operation cannot be restored with other means, and its rescue is in public interest. If resolution is possible, then the Council works out the resolution plan, which will be implemented by the national authority. If the bank cannot be saved from other sources, then the single resolution fund may be used, which will be gradually filled with the payments of the member states according to the plans. During the 8 year period, the capital of the Fund must reach EUR 55 billion, and the national resolution authorities will be integrated into the common fund of the EU.

Figure 2: The resolution process of the EU



Source: Windisch (2014)

The following means may be used during the resolution (Szanálás, 2017):

- Recapitalisation by creditors:
  If the bankruptcy is becoming increasingly likely, but there is hope for the rescue of the bank, then first the owners have to increase the capital (bail-in). The state may provide help subsequently (bail-out). The purpose is to make sure that the owners of the banks are liable for the bankruptcy of the institution instead of taxpayers. There is information asymmetry between the shareholders, the bank owners and the investors, i.e. the shareholders are aware of the rate of the risk undertaken by them, however, the investors possess only part of the information. The interest of the owners is to maximise their own profits, while they reduce the profit of the depositors. Deposit insurance fully protect the savings of the depositors up to EUR 100 thousand in the member states of the European Union. However, if the money of the owners is not enough, then the savings of the depositors exceeding EUR 100 thousand may be used by them, but recapitalisation by creditors is intended to make sure it happens only as a measure of last resort.
- Property sale:

Sale of the institution as a whole or part of it to another market operator (other than a bridge bank), which does not require the consent of the shareholders. If only part of the assets and liabilities is sold, then the non-sold part of the credit institution must be liquidated.

- Use of a bridge institution:
  Transfer of the bad assets and liabilities of the bank to an intermediate institution, a so-called bridge bank. As it is indicated by its name, it is only a bridge solution made until a buyer is found on the market for the institution under resolution. The bridge institution is partly or wholly owned by the state, and is controlled by the resolution authority.
- Asset separation:
  Separation of the good and bad assets of the institution under resolution, and this means may be used only in combination with another resolution means. The assets are generally transferred to a separate asset management organisation. It strives to maximise the value of the transferred assets for the purpose of potential sale in the future. The asset management institution is also partly or wholly owned by the state, and is controlled by the resolution authority.

Only one credit institution has been resolved in Hungary to date. The resolution of the Hungarian Commercial Bank war ordered by the National Bank of Hungary as the resolution authority in December 2014, because the prudent operation of the bank could not be further expected. All of the above means were used during the resolution, except for recapitalisation by creditors. In the first step, the real estate based credits of inferior quality liable for the situation were sold, then the assets were separated in relation to the non-marketable credits. Finally, the shares of the bank were sold in June 2016, and thereby the resolution procedure was finished. The resolution procedure was qualified by the European Commission as positive, since the protection of deposits and the restoration of the bank's operation were fully implemented (MNB, 2016).

In Cyprus, one of the biggest banks of the country was resolved in 2015. The institution faced severe lack of capital, however, the closure of the bank would have induced significant panic among the depositors, therefore finally the resolution authority decided on the use of property sales as a means of resolution, and the bank was liquidated subsequently (Kómár & Sulyok, 2018).

Both cases show that by means of the resolution the spread of the problem to other institutions and the panic among the depositors could be avoided, and the costs arising as a result were also considerably lower than the loss that would have been caused by the immediate bankruptcy of the credit institution in the whole economy.

4 Summary

Overall, it is found that the crisis has called the attention to several severe deficiencies and problems of the bank system, the solution to which has been started by the regulatory bodies. The establishment of the system of institutions of resolution at national and international levels significantly contributes to the avoidance of future bank crises. Probably the framework of resolution will change in the future e.g. deposit funds and insurances will use this method. Earlier resolution was current in the financial developed countries (USA, EU), but later other regions (Asia) began to use it because it is very important for the too big too fail banks due to the special nature of their activities (Kómár, 2019).

The resolution is beneficial for all operators. Though the savings of taxpayers are protected up to EUR 100 thousand and are paid back via the deposit insurance fund in compliance with the requirements of the EU, but the best case is when no compensation is necessary for the depositors. From this it is concluded that resolution is more favourable also for the deposit insurance company, because payments to the depositors are a considerable burden on the fund, and reduce the coverage. Resolution is a positive solution also for the bank owners, as the rescue of the credit institution becomes possible in a favourable case. There is no need for a state intervention, the depositors do not even know about the resolution of the credit institution, and thereby bank panic resulting from a bankruptcy can be avoided (Gyura, 2014).

In addition to the modern means of rescue of banks, prevention, i.e. the avoidance of the bankruptcy of the credit institution is still the most important aim. The directive of the European Union on the resolution provides that it is important for the authorities to do their best to maintain the financial stability before resolution is made. However, if a bank’s operation is in risk, the institution must be rescued with proper means to avoid any bank panic. The means of resolution will probably mitigate also the effects of these negative events on the economy and the society, while their use will become less and less frequent, and the resolution funds will be a new and stable element of the financial safety net at both national and EU levels.

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