Notes on Too Big To Fail following Wilson Ervin's presentation

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Summary

- A EU mutualized deposit insurance scheme will not solve the problem
- Doom loop is over-rated as the source of the problem – applies mainly to small countries
- Even more equity would be better than bailable bonds
- ELA a useful tool for the time…but its time may have largely passed, given alternatives now available
- Flip-flopping may not have ended
- Politics matters

Not discussed by Wilson but often cited as a fix-all: completion of the Banking Union through mutualized European deposit insurance:

What are the problems with European Depinsur?

(i) The national funds are not large enough - and the smaller sovereigns not credible as a backstop - for large bank failing with high % losses;

> This implies deposit insurance not fully credible in small countries limiting potential scale of banks with HQ in small countries (single market). Mutualization would solve this, but is not on the cards while creditor countries fear that legacy issues may still remain in small debtor countries.

(ii) The €100K ceiling is ok for protecting small depositors but

> (a) leaves politically influential depositors — individual and corporate—exposed (Northern Rock case);

> (b) is insufficient to protect against wholesale runs.

> AND THUS CANNOT FIX TBTF!

On the doom loop:

- For only a few smaller countries were bank bailout costs really material in threatening government debt sustainability. (Cyprus, Iceland, Ireland).

- (The other leg of the “doom loop” was more widespread (GR, IT, PT, as well)

- The disorderly failure risk was contained in US, UK and CH by “financially manageable” bailout costs; but politically and socially unacceptable, and a sizeable economically efficiency cost.

TLAC bailable bonds vs equity: (the two Charles debate)

- Do the bailable bonds provide an additional dimension to investor scrutiny (as was suggested years ago by Calomiris). Some merit in this argument.

- Or do they introduce a dangerously destabilizing element, with market value of the bailable bonds dropping sharply (over a cliff) at any hint of bad news (Goodhart). Even if so, should we worry—market price moves act like a canary in the coal mine, clearly flagging potential problems and prompting action.

- But: it is less easy to politically to bail-in bonds than to allow equity prices to fall to zero – the latter is a more or less well accepted risk by equity investors (NE, SV, ES) – more equity would be better.

- Interaction of ELA and resolution. – ELA can be a loophole potentially undermining the bail-in idea
- Fast money exits first; ELA may bear the brunt
- The early cases (IE, NE, DE), ELA may have been the best response at the time, given lack of preparedness at the time
- The 2016 ES case (Popular) had sparing use of ELA -- and rightly so

Table 1 Contrasting decisions on the provision of emergency liquidity assistance

Institution or country	Year	Emergency liquidity assistance
Northern Rock (United Kingdom)	2007	Not provided, then provided
Lehman Brothers (United States)	September 2008	Not provided
Germany, Belgium, Netherlands	September 2008	Provided
Ireland	September 2008	Not provided (until 2009)
Iceland	October 2008	Not provided, except for onshore offices
RBS and Lloyds (United Kingdom)	September 2008	Provided
Cyprus	2012	Provided, but capped in 2013
Greece	2011	Provided, but capped in 2015

Table 2 European bank creditor bail-in decisions: Contrasting cases

Institution or country	Year	Bail-in
Lehman and Washington Mutual (United States)	2008	Yes, but not since
Hypo RE (Germany)	2008	No; nonperforming loans purchased at book value
RBS and Lloyds (United Kingdom)	2008	No; government equity injection unlikely to be recovered (Similar 2008 cases in Belgium, France, and the Netherlands)
Greece	2012	No (despite restructuring of government debt)
Cyprus	2013	Yes (but not Greek branches)
Spain and Italy	2013–16	Yes for subdebt
Portugal	2014–15	Yes, but selectively

- Zig-zag / Flip-flopping in Europe — ELA and bail-in. Can only be rationalized in terms of lack of legal and institutional preparedness (and the scale and novelty of the problems faced)
- UK bailed-out systematically on 2007-8 but acted sufficiently decisively in 2008 to avoid need for subsequent action.
- US shifted to bail-out in Sept 2008; was not costly in the end; has nominally shifted back—but the new regime not yet tested!
- Has flip-flopping in EU ended with BRRD? Maybe not: cf. Popular and VV

Politics

- Will the new regimes be adhered to?

- Geithner says the new post-crisis US regime is too constraining, rather than what he sees as an extension of the scope of preventative action including, ELA, guarantees and asset purchases, it has introduced a variety of limitations on the freedom of action of the Fed and other agencies

- In Europe we have the BRRD, but the Italian V+V case (using loophole) looks close to an evasion/circumvention of the intentions of the authors of BRRD

- Part of the problem in surely that the new bail-in regime was introduced before the legacy issues from the crisis had been fixed. But the time for making that excuse has nearly passed nw.