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Who pays for bank insolvency?

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Abstract

This paper discusses proposals for handling bank failures in a manner that is: rapid enough to allow the business to continue, respects the ranking of claims, makes none of the parties worse off than under traditional insolvency and does not require taxpayer funds, except to guarantee the new organization until recapitalization. It considers the relationship between the regime for bank exit and the rest of the framework for regulation and supervision; the role of market discipline in enabling solutions before the point of insolvency is reached; the problems in assessing the costs of different exit regimes and public intervention.

JEL classification: G21; G38; K23

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1. Introduction

It is well known that the economic impact of the insolvency of banks poses different problems for society from the insolvency of non-financial companies and indeed from many other financial companies. These differences stem primarily from two causes: – the holding of deposits and the spill-over from a problem in one bank to others and to the rest of the economy.[1] The laws relating to insolvency try to provide a balance between the various groups exposed to the loss in the case of company failure – creditors, shareholders, customers, employees etc. – and some equality of treatment of those within each group. In the latter respect this often involves measures to co-ordinate the interests of large numbers of people with

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[1] In most industries, the spill-over from the failure of one firm to its competitors is positive—they pick up its customers and do not have any liability to pay for its losses, as is the case with deposit insurance.

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individually small exposures and little power and information. Views differ across societies about the appropriate balance but it is normally only those directly involved who have a say. Courts can determine that the rules for sharing the cost are properly applied in each case. While it is only natural that those about to make losses would like to shift the burden onto others, the case for external assistance from taxpayers through the government is usually weak. The authorities are thus not normally directly involved unless they are exposed to the direct loss in the normal course of business.[2] Having an efficient competitive economy involves entry, growth *and exit* of enterprises in a framework that gives confidence to the participants.[3] This includes the orderly exit of insolvent banks.[4]

In the case of non-financial companies, fully secured creditors may escape any losses. Insolvency may impose losses on the unsecured, such as suppliers who have not been paid for their deliveries and customers who have paid in advance. Customers who have already purchased and received delivery will face relatively little loss or inconvenience. (Indeed where there is substantial advance payment involved there are frequently insurance schemes available, as in the travel industry. Commercial law and practice address these possibilities.) In the case of bank insolvency, all existing depositors are unsecured and hence at risk. For some people, those deposits may represent a large portion of their savings. The insurance therefore needs to relate not just the customers involved in transactions at the time but to the balances of all customers. The scale and nature of what is involved is thus much greater. It has to relate to the stock of deposits and not just to the flow of current transactions.[5] Banks cannot seek temporary protection from their creditors to restructure their business and obligations like commercial companies, as that would involve interfering with the business of banking itself.[6]

Although ultimately the payout to creditors in the case of insolvency may be a substantial proportion of what they are owed, that process of payout can be slow, even if there are interim payments. If in the meantime customers cannot access their deposits, the consequences for their other transactions and indeed livelihood may be severe, leading to knock on failures to pay and drastic reductions in spending. This knock on will also occur through the banking system as banks have

[2] The role is of course different if fraud or some other criminal activity is involved.

[3] Carletti and Hartmann (2002) dispel one of the reasons often advanced for protecting banks. They conclude (p. 32) 'On the basis of the theoretical and empirical survey [in their article], the idea that competition is something dangerous in the banking sector, since it generally causes instability can be dismissed. In the light of the importance of the market mechanism for allocational efficiency and growth, competition aspects need to be carefully considered in industrial countries, also in banking'.

[4] In recent years, there has been quite a substantial development of texts setting out what the laws handling bank insolvency are and should be, including Oditah (1996), Ramsey and Head (2000), Asser (2001) and Campbell and Cartwright (2002).

[5] It is difficult to think of other instances where people are prepared to hold such important unsecured claims – banks are certainly not prepared to do this in transactions with each other. Collateral is normally required.

[6] A limited degree of protection is available for building societies and other institutions where a delay can be imposed on access to deposits.