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Blanket guarantee, deposit insurance and restructuring decisions for multinational banks

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ABSTRACT

This paper examines blanket guarantee, deposit insurance and restructuring decisions with respect to a multinational bank (MNB) using Nash bargaining when the threat of a bank panic motivates countries to make decisions quickly. Failure of the bank would unevenly distribute externalities across countries, influencing the restructuring incentives. In equilibrium, the bank is either liquidated or one of the countries – or both – recapitalizes it. A partition of the recapitalization costs is sensitive to the country-specific benefits and costs from recapitalization, panic and liquidation. The home regulator benefits from the advantage that it is the only entity that can legally liquidate the MNB. Rational expectations regarding the bargaining result affect the incentives to declare a blanket guarantee.

1. Introduction

The emergence of large and complex multinational banks (MNBs) has raised concerns that national supervision and crisis management practices – such as national deposit insurance schemes – should be redesigned to meet the requirements of the contemporary international financial markets. These concerns follow directly from the observation that managing of financial stability is no longer a national issue, as most policies targeted to restructure a distressed MNB involve cross-border externalities. Cross-border issues are especially important in the unified European financial system, where the number of pan-European banks is increasing and the largest institutions have systemic importance for the financial markets of multiple countries.[1]

The effects of an MNB failure vary among the countries concerned, which complicates cooperation, as national authorities pursue the policies they consider most beneficial for their country and their domestic financial system. The restructuring negotiations concerning Fortis in 2008 between the Belgian, Dutch and Luxembourg governments and central bankers offer a topical example. The unilateral closure of Lehman Brothers in the same year by the US authorities illustrates how the closure of a large and complex financial institution generates severe cross-border externalities. The restructuring decision might well have been different had there been cooperation between, for instance, the European and US authorities.

History has demonstrated that regulators are unable to establish a credible pre-commitment to a given policy scheme during banking crises. A similar commitment problem applies to any international ex-ante agreement on crisis management of an MNB, as the regulators cannot feasibly control for all states of the world in the contract. The most plausible prediction is that a crisis in an MNB

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[1] Schoenmaker (2009, p. 2) documents: 'Average cross-border penetration in the EU has gradually increased from 11% in 1995 to 21% in 2007. Turning to individual banks, the European Central Bank has conducted a mapping exercise of EU banking groups with significant cross-border activity. While the number of banks included in the analysis increased only slightly – from 41 to 46 between years 2001 and 2005 – the consolidated assets of the sample as a whole increased from 54% to 68% of overall consolidated EU banking assets.'

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will lead to ex-post negotiations between the affected countries on appropriate restructuring policy and burden sharing.

Most banking crises have demonstrated that once the first signs of distress in a bank emerge, the regulators have limited time to reach an agreement, because while the regulators are negotiating on appropriate intervention, uninsured depositors are likely to panic. The threat of panic motivates regulators to restructure banks quickly. The negotiations over Fortis provide a convincing example:

> 'Belgium was desperate to prevent panic, because Fortis is the country's biggest private sector employer and handles the bank accounts and insurance policies of 1.5 million Belgian households, or almost half the population.' (Financial Times 29 October 2008)

Take-over negotiations with other banks were unsuccessful, because the price offers were too low. Therefore, on September 28, 2008, Belgium, the Netherlands and Luxembourg organized a rescue plan worth of 11.2 billion euros to Fortis. Belgium promised to buy 49% of Fortis' Belgian banking unit for 4.7 billion euros, while the Netherlands pays 4 billion euros for the Fortis' Dutch banking business. Luxembourg provides a 2.5 million loan convertible into 49% of Fortis' share in that country. The original plan, however, was later changed.

This paper studies international cooperation in the design of restructuring policies of a failing MNB and its welfare implications. To this end, we develop a bargaining model where the countries try to find an agreement for restructuring the debt of an insolvent MNB and for sharing the associated costs. The outcomes of the game are dictated by three main features that are likely to emerge in such policy processes. The first feature is the allocation of regulatory responsibilities between the countries affected. The home-country regulator is the only entity with a legal right to liquidate the MNB. Another side of the same feature is that the closure of an MNB induces a cross-border externality in the form of real cost from the loss of value of uninsured deposits. The externality motivates the host country to participate in the costs conditional on the home country not liquidating the MNB, but agreeing to the recapitalization of the bank. The second feature is the limited time the regulators have to reach an agreement, as postponing the decision to a further round of negotiations increases the probability of panic. This feature affects the bargaining power of the regulators, as the likelihood that after the initial offer the bargainers can reconvene at the negotiation table becomes small.

The third feature is related to the prevention of panic using a blanket guarantee. In many financial crises, regulators attempt to mitigate panic by extending deposit insurance coverage and declaring a blanket guarantee. Blanket guarantee is usually established when the first signs of distress emerge, but before the bank becomes legally insolvent. Again, the situation in the fall of 2008 provides an example:

> 'The treasury was under pressure last night to guarantee the savings of all depositors in British banks after Germany announced it was following the lead of Ireland and Greece and offering a blanket guarantee on all savings.' (Guardian, 6 October 2008)

The main contributions of the paper illustrate that cooperation is welfare superior to unilaterally designed restructuring decisions regarding an MNB, but the cooperation outcomes allocate the welfare benefits unevenly among the countries. Firstly, we show that an optimal unilateral policy for the home country calls for liquidation, the bargaining equilibrium exhibits recapitalization, which maximizes the joint welfare of the countries. This result supports the argument that MNBs are more likely to become subjects of bailout policies when the regulators have the option to split the fiscal burden of costly recapitalization. Second, the cost allocation is sensitive to country-specific bargaining power, which is determined by the expected costs from recapitalization, bank liquidation and those emerging from bank panic. The home regulator benefits from the privilege that it is the only entity that can legally liquidate the MNB. But the position of the home country becomes weaker when the share of insured deposits is high, as the host country has limited incentives to share the regulatory cost burden of the home country. In equilibrium, one of the countries may recapitalize the MNB alone, or the countries may jointly recapitalize it. Sometimes the optimal solution is achieved when the countries decide to liquidate the MNB. Third, if uninsured deposits are subordinated to insured deposits, the liquidation decision becomes more likely. The subordination decision also boosts the bargaining power of the home country.

The results regarding blanket guarantees show that a blanket guarantee is optimal under certain conditions and, in a similar manner as in the ex-post restructuring decisions, efficient implementation of the policy calls for cooperation between the countries. The conditions where a blanket guarantee is optimal are the following. When the regulators anticipate that MNB will be recapitalized should it become insolvent, it is optimal to declare a blanket guarantee. Otherwise, a blanket guarantee is declared if the risk of bank insolvency is small and the probability of a costly panic is high. Efficient design of a blanket guarantee calls for cooperation, because the cross-border externalities diminish the incentives of the home country regulator to minimize the expected joint costs of a failure. This indicates that the countries should renegotiate over the partition of the recapitalization costs concurrently with the declaration of the blanket guarantee, even though the MNB is still solvent and may yet avoid failure.

The paper is related to two strands in the literature. One strand is Nash's (1950) classic bargaining theory. On these issues Muthoo's (2002) provides an extensive survey. The second strand of the literature consists of analysis on banking crises and bank restructuring: e.g. Merton (1977), Mailath and Mester (1994), Aghion et al. (1999), Mitchell (2001), Repullo (2001, 2004, 2005), Hothausen and Ronde (2002), Holthausen and Ronde (2005), Acharya (2009), Niinimäki (2009, forthcoming), Dewatripont and Rochet (2009) and Borio et al. (2009). Repullo (2001), Calzolari and Loranth (2005) and Holthausen and Ronde (2005) present models on multinational banks.[2]

The paper extends the existing literature on the regulation of multinational banks in the following directions. Holthausen and Ronde (2005) examine closure regulation, when it is possible to close a bank or leave it open. Regulators in both countries have access to private information that is relevant to the closure decision. Our approach differs from that in Holthausen and Ronde (2005) in several aspects. In their analysis, regulators are asymmetrically informed and exchange information, whereas in our model regulators have perfect information about the financial status of the MNB, which is in line with the consolidated supervision principle within the EU. Asymmetric information in our model is between the regulators and the market and revealed to the market through exogenous technology. This emphasizes the feature that a rapid decision is required in efforts to solve banking crises, because market reactions exacerbate the problem.

With respect to the equilibrium closure policies of a cheap-talk game between the regulators, Holthausen and Ronde find

[2] Although theoretical and empirical research is scarce, the regulation of multinational banks has created active debate: e.g. Mayes and Vesala (1998), Calzolari and Loranth (2001), Eisenbeis and Kaufman (2008), Goodhart (2008) and Krimminger (2008).