After 2009 great recession, should banks be allowed to go into bankruptcy?

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<u>Work Description</u>

The report is written by all the participants in the group. The group has worked together and been equally invested in the project, by discussing and researching information.

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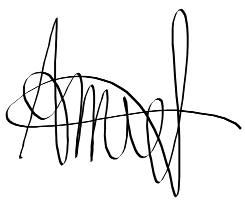

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1 Introduction

During the Great Recession, many banks needed to declare bankruptcy. This paper is going to highlight the main historical points of the Recession 2007-2009, go over some case studies of bankruptcy in the financial sector during this time and analyze general corporate bankruptcy law and its inadequacies to the specific features of banks as corporations. Finally, the group's personal reflections on the topic will be at the end as a conclusion to all the information exposed.

The aim of this paper is to learn more about the topic at hand and to invite our classmates to read more about it.

2 Historical background for the Recession of 2009

The two decades before 2007 were prosperous, characterized by economic growth and political stability in the U.S. This led the people to think that the economy would have continued to flourish and the banks started a profitable mortgage lending strategy, denoted by low interest rates and without the appropriate controls on applicants' credit score. This strategy found fertile ground especially because ten years before 2007 the real estate and property prices had risen.

Consequently, people started to buy homes and to invest in properties leading to a boom of the residential housing market, which became a bubble. The application of subprime mortgages, adjustable-rate mortgages which were low-charged, denoted by having affordable payments initially, followed by higher payments in the years thereafter, made riskier the already unstable financial situation of the U.S. economy. In the rush to take advantage of a hot market and low interest rates, many homebuyers took on loans without knowing the risks involved, guided by the conception that subprime loans were safe, since real estate prices were considered sure to keep rising.

Lenders also earned money by selling and reselling mortgage loans in securitizations, in particular subprime lenders sold mortgage-backed securities to investors around the world and sold bundled loans to investment banks. Consequently, investment banks started repackaging and selling mortgage-backed securities on the secondary market as collateralized debt obligations (CDOs). In the first periods, the market seemed stable, so investors did not mind adding to their debt, because institutional investors and investment banks borrowed large sums at short-term rates worldwide, in order to buy CDOs. Finally, overheating economy and the fear of inflation made the interest rates start to rise.

During the second half of 2008, the U.S. financial market, and afterwards all major world markets, were devastated by the aftermath of these unethical lending practices by major institutions. Arguably, their own interests made them put aside ethical judgement, leading to this debacle [3]. The real estate market's collapse caused a domino effect resulting in the collapse of major banks and an alarming drop in market stock values, financial companies, insurers, and eventually led to the biggest financial crisis since the Great Depression.

2.1 Some real world examples

The Northern Rock Collapse

Northern Rock was born in 1965 as a building society, focusing mainly in residential lender owned by its savers and borrowers and decided to go public in the stock market in 1997. In just 9 years, it became the fifth-largest mortgage lender in the world, growing from £17.4 billion to £113.5 billion in total assets. In September 2007, due to an heavily rely on securitization and short-term funding from wholesales markets, Northern Rock was the first casualty of the big recession crisis and a few months later, it was nationalized by the British Government, to end up being split into an asset-management company and a banking unit in 2010.

The business model adopted by Northern Rock was divided mainly in three parts: borrowing on a short-term basis (both from domestic and international investors), extending the funds through mortgage lending to costumers and repackaging and reselling these mortgages loans. Unfortunately, after the closure of three investments funds operated by BNP Paribas, the bank faced the impossibility of raising funds in the money market for repaying back its short-term loans. To replace its funds, Northern Rock asked and got liquidity support to the Bank of England in September 2007, but the actions made by the group scared the depositors and let to the collapse of the share price on the stock market.

Finally, to calm the markets and because Northern Rock was not able to completely give back the taxpayer's money, the bank was nationalized in February 2008.

The Lehman Brothers Bankruptcy

The Lehman Brothers group was born in 1850 and always identified itself as a nonbank global financial services firm, operating worldwide. As we all know, The Lehman Brothers faced a huge loss during the 2009 big recession crisis, due to its large position on the subprime mortgage market and other lower-rated securitized mortgage tranches. On September 2008, the company fell into bankruptcy with a total debt of 613 billion USD.

The bank found itself in that position accumulating large position in real-estate related products. Until the mid of 2007 Lehman had steady profits, but after a few months it incurred huge losses. As a result, the share price fell dramatically. Private solutions were thought, for example Korea Development Bank, Barclays and Bank of America considered to acquire the group, but none of them went through.

The Lehman Brother's strategy was wrong in many ways, but highlighted that the bank was not subject to the same regulation applied to commercial banks. Furthermore, it would have been extremely important to have a framework for orderly resolution and the presence of emergency funds that could have provided liquidity without causing damages neither to firm's key operations nor to outgoing trading commitments.

In the end, the Federal Reserve provided liquidity and helped the failing bank to find an acquirer.

The Fortis Bank Bankruptcy

The Belgian-Dutch Fortis group used to be one of the largest businesses by revenue in the world right before the crisis started. In 2007, Fortis acquired the Dutch bank ABN AMRO, becoming the largest takeover ever in banking history. Unfortunately, this happened only two months after the onset of the U.S. subprime mortgage market crisis.

The Belgian-Dutch group was affected by the situation overseas and the distress caused by this and the recent takeover led them to cancel dividend payments. This measure caused the Fortis share price to plummet to a 15-year low and for business and institutional clients to pursue large withdrawals.

In September 2008, the Belgian government had to step in and ended up nationalizing the bank in a joint intervention with the Netherlands and Luxembourg. A total of €11.2 billion was injected by the Benelux governments. However, this did not calm the market as conflicts of interest and responsibility between Belgian and Dutch regulators and Fortis shareholders arose. This episode revealed that banking authorities in Belgium (and the Netherlands) did not have sufficient legal power to respond to banking distress in a timely and efficient manner.

Finally, the Belgian government sold most of its shares to the Dutch government and BNP Paribas

3 Bankruptcy Law

3.1 Corporate Bankruptcy Law

Bankruptcy law for corporations arises from the need to coordinate the several creditors of the company. Upon a perceived problem with the corporation, creditors might prefer to be on the safe side and race to collect their debt or sue the corporation in order to be repaid first. This can trigger the premature liquidation of the corporation driving it to bankruptcy.

Bankruptcy law aims to mitigate this coordination problem. However, this is not an easy task. The proceedings are usually aimed to facilitate negotiations between creditors and shareholders. These negotiations could be held privately, but the need for unanimity in the creditor board might cause that just a small creditor could hinder the whole operation (*hold-out problem*). Bankruptcy law aims to solve the hold-out problem because the corporation in bankruptcy needs less than unanimous support of the creditors for restructuring.

An important objective when designing bankruptcy law is to set a trigger for bankruptcy. In this respect, a crucial point is who can declare bankruptcy and under what conditions.

When it comes to the *who*, as reasoned previously, a creditor-friendly law would help with coordination problems and avoid the race to collect the debt, but it could lead to premature liquidation. Meanwhile a debtor-friendly law would help mitigate the hold-out problem, but it might lead to strategic bankruptcy declarations to get rid of debt. This can be further analyzed in the *ex-ante* (before the fact) vs. *ex-post* (after the fact) perspective.

3.1.1 Ex-ante

In the *ex-ante* sense, a good bankruptcy law should set optimal incentives and behavior from debtors and their creditors before bankruptcy occurs by specifying a debt contract between both parts. In a standard debt contract, the creditor has the right to a fixed payment and the debtor to the residual. However, if the creditor cannot be repaid, the bankruptcy occurs with the debtor receiving nothing and all the proceeds going to the creditor. Guaranteeing high payoffs to creditors in the case of bankruptcy presents a notable threat to managers, creating the incentive to make sufficient efforts.

Nevertheless, when the firm approaches bankruptcy, the need for creditor-friendly bankruptcy law is less evident. In this case, the manager of a failing corporation will try to postpone bankruptcy to the detriment of creditors by hiding losses through the use of creative accounting, or simply modifying cash flows.

3.1.2 Ex-post

From the *ex-post* point of view, the debtor-friendly bankruptcy law may be more efficient. It tries to minimize the cost of bankruptcy and at the same time leads to optimal asset utilization. Debtor-friendly bankruptcy law also removes the fear of initiating bankruptcy procedures early, avoiding bad practices and gambling behavior. Debtors will also put more effort in restructuring and take acceptable levels of risk when in bankruptcy.

Good restructuring can also avoid losing value. However, debtor-friendly bankruptcy law may have as a consequence that inefficient manager and owners stay in control of the firm.

3.2 What is different about banks?

Banks are a special kind of corporation, which makes regular corporate bankruptcy law not optimal to resolve bank bankruptcy. Specially, this is given by the banks being also liquidity providers, even to the creditors. Unlike corporations, bank bankruptcy law can only impose an automatic stay[1] on bank creditors at a high cost because that would destroy one of the key functions of a bank: its liquidity provision.

On the other hand, trust in the financial sector is crucial. Distrust in the system might cause panic withdrawal runs, turning the distrust into a self-fulfilling prophecy. Additionally, a bank failure has a large negative influence in the economy as a whole. Banks are interlinked and freezing liabilities (capital and deposits) could create insuperable problems for other banks and provoke systemic risk. The social cost of a bank failure exceeds the private cost and corporate bankruptcy law largely neglects this social cost.

Also, banks are subject to prudential regulation and rely on implicit government guarantees, which interfere with the bankruptcy procedures in an ex-post point of view. Taking into account their inter-connectivity, regulators choose to prevent individual banks from failing. When a bank becomes “too big to fail”, “too complex to fail,” or “too interconnected to fail”, the regulator may not be able to close the bank without damaging the stability of the system and the economy. In such situations, the regulators will seem to be forced to bail out banks in order to prevent systemic crisis.

Finally, banks’ various activities are often supervised by several regulatory agencies. Coordination among these authorities creates conflicts of objectives and requirements, complicating the situation, as we saw with Fortis. This gets exponentially complex for international banks, since there will be different regulatory agencies in each country.

[1] Mandate in U.S. bankruptcy law that temporarily prevents creditors, collection agencies, government entities, and others from pursuing debtors for money that they owe

3.3 Bank Bankruptcy Law

The general feel before the 2007–2009 financial crisis was that prudential regulation should stop banks from entering distress and that, as a consequence, banking failures can be prevented. While prudential regulation (e.g. Basel I and II) is needed to contain excessive bank risk-taking, it does not eliminate the possibility of bank failure.

Furthermore, corporate bankruptcy law is not well suited for banks, due to their special characteristics, and a more specific Bank bankruptcy law should be in place. Marinč et al.[4] propose a series of requisites that this sort of law should satisfy, out of which these stand out to us:

- **Explicit objective: prevent systemic banking crisis**
- **Additional objectives**
    - minimizing costs for taxpayers
    - respecting priority rights
- **A pre-insolvency phase should exist**
  This would give the regulator the opportunity to intervene a weak bank in a timely manner. The idea is to prevent insolvency of the bank and make the bank shareholders (and not the creditors) responsible when problems are still containable. Corporate control should be shifted gradually to bank creditors.
- **The regulator should lead the restructuring and not the court**
  And the regulator should have greater power than the court has in corporate bankruptcy.
- **Should be less debtor-friendly than corporate bankruptcy law**
  The regulator should have the authority to remove management and shareholders and needs power to transfer assets from a failed bank in order to separate bad assets from good ones and increase transparency
- **The regulator needs to have tools for efficient reorganization**
  Optimal reorganization can be implemented only if financial authorities have available a comprehensive set of tools, such as liquidation, acquisition by a private-sector purchaser, purchase and assumption agreement or nationalization.
- **A restructuring fund should be established**
  The regulator needs to have funds available for the intervention. Banks should establish a restructuring fund that they should contribute to in times of economic growth.
- **Prudential regulation should be strengthened**
- **Should be harmonized across countries**

It is worth mentioning that in recent years, governments are already making efforts towards a Financial Institution specific bankruptcy law, [1].

4 Conclusion

Allowed or not, no one can avoid that banks fail from time to time. However, be it caused by negligence, reckless risk taking or incompetence, there must be a person or group responsible for the bank going bankrupt. All literature on bankruptcy deals with the practicalities of what to do when it occurs and how to avoid it in the first place, but there is no mention of accountability. All sorts of preventive funds and regulations can be mandated but if reorganization tools do not work and the tax payers end up being the ones bailing out the banks ex-post, they deserve to be paid back in the long run and the responsibles for this systemic financial distress must be brought to justice.

All things considered, the social and systemic costs of a bank failing are paramount, over the costs that it might entail to the bank as a corporation. Therefore, a special emphasis on legislating the pre-insolvency phase should be prioritized to avoid the damages of a bankruptcy in the first place. In case it needs to declare bankruptcy, the bank should only be allowed to do so under the conditions previously proposed, in order to protect society and the system.

5 References and reading list

References

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Reading list

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