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Bank bail-ins: needed, or misguided? [1]

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Like other businesses, banks get money from shareholders. When a business fails, the shareholders are first to take the hit. And banks also raise money from bondholders ? investors who give them cash in return for an IOU. But in the recent financial crash, innocent taxpayers bailed out the banks ? the bondholders were largely unscathed. So now there are moves towards a ?bail-in? system ? where bondholders forfeit before taxpayers do.

It?s good politics, but is it good finance? I?m really not sure. If bondholders face higher risk, they will demand higher interest. Banks will have to pay more to raise money, and will pass on the higher interest charges to customers. Right now, that could tip a number of businesses and families over the edge.

There are established legal rules about who loses what when a firm gets into trouble; but the ?bail-in? proposals would see regulators deciding who pays what. That?s a recipe for injustice: one can easily envisage regulators discriminating in favour of domestic bondholders, for example, and against foreign ones ? after all, the foreigners have no votes. And among domestic investors too, those with political clout are likely to be favoured over others.

When things are booming, of course, bail-in bonds will look safe as houses, and their value will rise. But the slightest doubts about the security of a bank will see them plummet. Like the Basel II capital rules, people will find themselves selling off other assets to raise cash ? depressing the price of what they are trying to sell and forcing them to sell even more in a market spiralling downwards. Bail-in bonds might well worsen the panic and losses that go with financial crises.

When banks run out of credit and investors run out of cash, the only agency left standing is the central bank. And traditionally, central banks have been the lender of last resort to a struggling banking system. Which means taxpayers? cash is called on. Some people argue that this is in fact far less messy than forcing bondholders and others to try to raise cash fast on a falling market ? which inevitably brings real losses.

Equally, I do not see why taxpayers should be called on to save any business that has got itself into a mess. Is banking any different? Perhaps it is. But only because of the fractional reserve system, the government guarantee of depositors? funds, and the fact that the huge burden of bank regulation stifles competition in the sector. A better solution is, like Switzerland, to have much higher capital requirements on larger banks ? so encouraging the banks to split themselves up, and encouraging new banks to start up. Competition is the best regulator.

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