SC15023

ARE BAIL-INS THE FUTURE?

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ABSTRACT

The recent global financial crisis forced governments to rescue financial and other private institutions. The governments of the U.S. and Europe "*bailed-out*" institutions by injecting large sums of money which recapitalized major American financial institutions and supported the Euro. This was done on the backs of taxpayers and has created political backlash, resentment, and bailout fatigue.

Unfortunately, such fiscal policies have increased the debt to GDP of many countries and monetary loosening has led to possible asset inflation in the real estate and stock markets. Today, the hangover from the financial crisis still lingers and the financial institutions of many countries are still highly leveraged.

The Cyprus' banking crisis triggered a different response - the "*bail-in*". Bondholders and depositors (with more than 100,000 Euros) were forced to write-off a portion of their holdings. Although the authorities said the Cyprus case was a one-time event, most G20 countries have legislated similar "bail-in" policies. The purpose of these bail-in policies is to avoid using solely taxpayer funds to bail-out additional failed banks while at the same time preventing systemic economic instability from bank failures. The risk of losses will be assumed by the bank bondholders and also by the depositors whose money in the bank exceeds the amount guaranteed in the deposit insurance scheme (FDIC for U.S. for example). At least that's the theory of most of the bail-in policies.

The reality of bail-ins might prove to be very different. In June 2014, BlackRock and PIMCO filed a $250 billion lawsuit against several banks for breach of fiduciary duties. If the amount recovered is anywhere close to the amount asked, the size of the judgment could swamp the FDIC's insurance guarantee fund (currently estimated at around $41 billion). That means that while in theory the FDIC bank guarantees would remain in place, without additional funding, they would not be able to return depositors money within the insured limits in a timely manner. That would send shockwave across the entire banking system in short order.

The Financial Stability Board (FSB) which consists of global regulators and central bankers are working on proposals on bail-ins of creditors including banks' depositors. The purpose of such proposals is to prevent another "Lehman" moment where its collapse precipitated the global economic crisis. The question is what does this mean for financial institutions – their shareholders, bondholders and depositors? This paper will examine this question and evaluate what this change in philosophy will mean for market participants.