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Economics focus

From bail-out to bail-in

In a guest article, Paul Calello (pictured left), the head of Credit Suisse's investment bank, and Wilson Ervin, its former chief risk officer, propose a new process for resolving failing banks

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WHAT should policymakers do when faced with the potential failure of a large bank? In 2008 officials had to choose between taxpayer bail-outs (bad) or systemic financial collapse (probably worse). Various ideas to make finance safer, like contingent capital and living wills, are circulating today. But the central issue of bank resolution, perhaps the most vexing aspect of the financial crisis, has not been clearly addressed.

A "bail-in" process for bank resolution is a potentially powerful "third option" that confronts this problem head-on. It would give officials the authority to force banks to recapitalise from within, using private capital, not public money. The concept builds on time-tested procedures that have been used to keep airlines flying and industrial firms going even as their capital structures were being reorganised. It accelerates those procedures to address the unique circumstances of financial firms operating in today's fast-moving markets. If done correctly it should strengthen market discipline on banks and reduce the potential for systemic risk.

The best way to understand the idea is to look at how a bail-in could have changed the outcome for Lehman Brothers over that fateful weekend in September 2008. Despite intensive efforts to find a better alternative, the bankruptcy of Lehman became unavoidable by the end of the weekend. When the two of us left the New York Federal Reserve on Sunday night, we knew that the financial landscape was in for a seismic shock.

Sunday, bloody Sunday

So it proved. According to market estimates at the time, Lehman's balance-sheet was under pressure from perhaps $25 billion of unrealised losses on illiquid assets. But bankruptcy expanded that shortfall to roughly $150 billion of shareholder and creditor losses, based on recent market prices. In effect, the company's bankruptcy acted as a loss amplifier, multiplying the scale of the problem by a factor of six. This escalated the impact elsewhere in the financial system. For example, the Reserve Primary Fund, a large money-market fund, "broke the buck" the next day, leading to severe pressure on other funds. A bail-in during the course of that weekend could have allowed Lehman to continue operating and forestalled much of the investor panic that froze markets and deepened the recession.

How would it have worked? Regulators would be given the legal authority to dictate the terms of a recapitalisation, subject to an agreed framework. The details will vary from case to case, but for Lehman, officials could have proceeded as follows. First, the concerns over valuation could have been addressed by writing assets down by $25 billion, roughly wiping out existing shareholders. Second, to recapitalise the bank, preferred-stock and subordinated-debt investors would have converted their approximately $25 billion of existing holdings in return for 50% of the equity in the new Lehman. Holders of Lehman's $120 billion of senior unsecured debt would have converted 15% of their positions, and received the other 50% of the new equity.

The remaining 85% of senior unsecured debt would have been unaffected, as would the bank's secured creditors and its customers and counterparties. The bank's previous shareholders would have received warrants that would have value only if the new company rebounded. Existing management would have been replaced after a brief transition period.

The equity of this reinforced Lehman would have been $43 billion, roughly double the size of its old capital base. To shore up liquidity and confidence further, a consortium of big banks would have been asked to provide a voluntary, multi-billion-dollar funding facility for Lehman, ranking ahead of existing senior debt. The capital and liquidity ratios of the new Lehman would have been rock-solid. A bail-in like this would have allowed Lehman to open for business on Monday.

Many investors would no doubt complain about the rough justice of a regulator-imposed reorganisation. To preserve value, officials would have to move very, very quickly, leaving little time to fine-tune various claims or observe normal procedures. The new structure would be based on bankruptcy reorganisation principles, allocating value in accordance with investors' seniority and ensuring that each class of investors would be better off than in liquidation. The process would not be pretty but overall, investors should be relieved by the result. In this example the bail-in would have saved them over $100 billion in aggregate, and everybody—other than short-sellers in Lehman—would have been better off than today.

Why can't the bankruptcy code do this today? To an insolvency professional, this restructuring looks somewhat like a "prepackaged" bankruptcy, in which creditors agree to a new, less leveraged capital structure negotiated over a period of months. But a lengthy, voluntary process is impractical in the panic surrounding the failure of a very large, complex financial institution. Even the recent “fast-track” reorganisation of CIT, a small-business lender, took 38 days. Lehman had only 48 hours before its liquidity and customer franchise would have been irrevocably damaged. A resolution framework for a large financial organisation must allow a recapitalisation to be implemented much faster than today's bankruptcy rules allow.

I do like Mondays

Would shareholders and creditors invest in a big bank given the risk of a forced recapitalisation? We think so. After all, investors buy securities that carry the risk of a similar restructuring today. Any extra cost of capital should be quite limited because the losses from a bail-in resolution are so much smaller than the losses at risk in a liquidation. A well-designed bail-in process would also be more predictable for creditors than the wide range of resolution outcomes seen in the crisis.

There are, no doubt, numerous legal and regulatory issues to be overcome for a bail-in to work. Sceptical customers and counterparties would still need to be convinced to deal with the new company. The process would need to be flexible so it could handle a variety of possible situations. But this proposal offers a powerful new way to recapitalise financial institutions using a bank's own money, rather than that of taxpayers. It would help design resilience and discipline directly into the banking system and prevent individual problems from turning into systemic shocks. Wouldn't that be a Monday morning worth fighting for?

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